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v.
David Strumpf

Docketed:
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Court: United States Court of Appeals for the Fourth Circuit

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1	Feb 6 1995	G	Petition for writ of certiorari filed.
2	Feb 6 1995		Appendix of petitioner filed.
4	Mar 7 1995	X	Brief amici curiae of NationsBank, N.A., et al. filed.
5	Mar 7 1995	X	Brief amicus curiae of American Bankers Association filed.
3	Mar 8 1995		DISTRIBUTED. March 24, 1995 (Page 3)
6	Mar 8 1995	X	Brief amicus curiae of United States filed.
7	Mar 8 1995	X	Brief amicus curiae of Credit Union National Association, Inc. filed.
9	Mar 9 1995	X	Brief of respondent David Strumpf in opposition filed.
10	Mar 9 1995	X	Brief amicus curiae of BankAmerica Corporation filed.
11	Mar 27 1995		Petition GRANTED.
			**********
12	May 11 1995		Joint appendix filed.
13	May 11 1995		Brief of petitioner Citizens Bank of Maryland filed.
14	May 11 1995		Brief amicus curiae of United States filed.
15	May 11 1995	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
16	May 11 1995		Brief amicus curiae of BankAmerica Corporation filed.
17	May 11 1995		Brief amici curiae of New York Clearing House Association, et al. filed.
18	May 22 1995		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
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20	Jul 12 1995		Reply brief of petitioner filed.
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25	Oct 3 1995		ARGUED.

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IN THE

Supreme Court of the United States

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights, without violating the bankruptcy stay under 11 U.S.C. § 362(a).

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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Citizens Bank of Maryland respectfully petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at 37 F.3d 155 (4th Cir. 1994) and appears as Appendix A to this Petition.

The decision of the United States District Court for the District of Maryland is reported at 138 B.R. 792 (D. Md. 1992) and appears as Appendix B to this Petition.

The ruling of the United States Bankruptcy Court for the District of Maryland is not reported. A copy of the bankruptcy court's Order appears as Appendix C to this Petition.

JURISDICTION

The United States Court of Appeals for the Fourth Circuit entered its judgment on October 13, 1994. The court

of appeals entered an order denying Citizens' Motion for Rehearing or, in the Alternative, Suggestion of Rehearing In Banc on November 8, 1994. A copy of this Order is attached as Appendix D. Citizens files this Petition for Writ of Certiorari within ninety (90) days of that date. Citizens invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case principally involves consideration of five sections of the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq.[1] They are 11 U.S.C. § 362(a)(7), 11 U.S.C. § 363(a), 11 U.S.C. § 506(a), 11 U.S.C. § 542(b) and

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[1] The United States Bankruptcy Code is hereafter sometimes referred to as the "Bankruptcy Code."

11 U.S.C. § 553. The text of each of these sections is set forth in Appendix E to this Petition. None of the provisions of the Bankruptcy Code at issue in this case has been amended by the Bankruptcy Reform Act of 1994, enacted on October 22, 1994, in a manner material to the outcome of this case.

STATEMENT OF THE CASE

On January 25, 1991, David Strumpf ("Strumpf" or the "Debtor") filed a bankruptcy petition in the United States Bankruptcy Court for the District of Maryland seeking relief under Chapter 13 of the Bankruptcy Code. The bankruptcy court had jurisdiction under 28 U.S.C. § 1334(a).

At the time the bankruptcy petition was filed, Strumpf had a demand deposit account with a balance of $11,279.86 at

Citizens Bank of Maryland ("Citizens"),[2] and owed Citizens the sum of $3,250.48 in connection with a consumer loan which was in default.

On October 7, 1991, Citizens filed in the bankruptcy court a motion for relief from the automatic stay, pursuant to 11 U.S.C. § 362(d), to permit Citizens to exercise its right to set off Strumpf's debt to Citizens against funds held on deposit and due to Strumpf. Citizens simultaneously placed an "administrative hold" on $3,500 in the Strumpf account. On October 9, 1991, Strumpf filed a motion to hold Citizens in contempt for violation of the automatic stay.

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[2] Pursuant to Supreme Court Rule 29.1, Citizens discloses that Citizens Bank of Maryland is a wholly owned subsidiary of Citizens Bancorp. Citizens Bank of Maryland has no subsidiaries, other than wholly owned subsidiaries.

On November 7, 1991, the bankruptcy court held a hearing on Citizens' motion for relief from the automatic stay, at the conclusion of which the bankruptcy court reserved its ruling on the merits. On November 13, 1991, the bankruptcy court held a hearing on Strumpf's motion to hold Citizens in contempt, and granted the motion. The bankruptcy court held Citizens in contempt for violation of the automatic stay and awarded Strumpf attorneys' fees of $500.00, punitive damages of $375.00 and nominal damages of $25.00.

Ironically, the bankruptcy court subsequently granted Citizens' motion for relief from the automatic stay on December 2, 1991. By that time, however, Citizens was unable to effectuate a setoff, because Strumpf had withdrawn all

of the funds from his account after Citizens lifted the administrative hold in response to the bankruptcy court's November 13, 1991 ruling.

Citizens appealed the decision of the bankruptcy court to the United States District Court of Maryland (the Honorable John R. Hargrove). The district court reversed the bankruptcy court, holding that the imposition of an administrative hold on Strumpf's account did not violate the automatic stay, where Citizens moved immediately for an order seeking authority to exercise its setoff rights. See Citizens Bank of Maryland v. Strumpf, 138 B.R. 792, 794 (D. Md. 1992).

Strumpf then appealed to the United States Court of Appeals for the Fourth Circuit, which reversed the district court's ruling and remanded the case for

reinstatement of the bankruptcy court's Order. See Citizens Bank of Maryland v. Strumpf, 37 F.3d 155, 159 (4th Cir. 1994). The opinion of the court of appeals construed the administrative hold as "tantamount" to a setoff. The court further reasoned that the brief length of time between a creditor's imposition of an administrative hold and such creditor's request for permission to exercise its right of setoff had no bearing on whether the creditor violates the automatic stay. Id. at 158-59.

REASONS FOR GRANTING THE PETITION

I. THIS CASE PROVIDES THE COURT WITH THE OPPORTUNITY TO RESOLVE WIDESPREAD CONFLICT AMONG LOWER COURTS CONCERNING EXERCISE OF THE RIGHT OF SETOFF IN BANKRUPTCY.

Whether a creditor with a right of setoff may refuse a bankrupt's request to pay money due to the debtor otherwise

subject to setoff, pending the bankruptcy court's determination of the creditor's setoff rights, is one of the most fundamental unresolved issues of insolvency law. During the sixteen years since the enactment of the Bankruptcy Reform Act of 1978, confusion and division on this issue have developed unabated. This case presents the Court with an opportunity to return the law governing setoffs in bankruptcy cases to the carefully balanced statutory framework established by Congress in the Bankruptcy Code. By reviewing the decision below, this Court will prevent further confusion, among creditors and debtors alike, with regard to the proper disposition of funds held in a bank account which are subject to a creditor's right of setoff and which are treated as

the bank's collateral under § 506(a) of the Bankruptcy Code.

A. The Circuit Courts Of Appeals Are Divided On The Effect Of A Creditor's Exercise Of Its Rights Under § 542 Of The Bankruptcy Code.

In this case, Citizens sought permission from the bankruptcy court to exercise its right of setoff against Strumpf's deposit account, to the extent of Strumpf's debt to Citizens. Citizens' right of setoff is recognized expressly in § 553 of the Bankruptcy Code. To preserve that right of setoff, Citizens refused to honor Strumpf's demand to withdraw funds from his deposit account. Citizens' declination to pay money to the Debtor to the extent of the Debtor's defaulted loan to Citizens is authorized by § 542(b) of the Bankruptcy Code. To maintain the status quo and prevent

withdrawal of the funds while it sought relief from the automatic stay to exercise its setoff rights, Citizens placed an "administrative hold" on Strumpf's account.

The Fourth Circuit couched the issue as one of "first impression" among the circuit courts of appeals. In the narrow sense of the issue of the appropriateness of the use of an "administrative hold" by a commercial bank, that characterization is correct. Viewed in a more appropriate broader context, however, the administrative hold at issue in this case is nothing more than a refusal by a creditor (here, a bank), which both owes money (a deposit account) to a debtor and also is owed money by the debtor, to honor a debtor's payment request to the extent of the debtor's obligation.

The circuit courts of appeals are divided on this broader question of whether such a refusal is permitted before relief from the automatic stay is granted. The Third, Fourth and Eighth Circuits have held that it is not. See Small Business Admin. v. Reinhardt, 887 F.2d 165, 169 (8th Cir. 1989) (SBA not permitted to place administrative hold on payments due to the debtor under farm program); United States v. Reynolds, 764 F.2d 1004, 1007 (4th Cir. 1985) (IRS not permitted to place administrative hold on debtor's tax refund); United States v. Norton, 717 F.2d 767, 774 (3rd Cir. 1983) (same). These courts hold that an administrative hold is equivalent to the exercise of setoff rights and, therefore, violates the automatic stay of § 362(a)(7) of the Bankruptcy Code.

Alternatively, the administrative hold is viewed as an attempt to exercise control over property of the debtor, violative of § 362(a)(3).

The Eleventh Circuit, by contrast, does permit a "hold" of an account, at least for a brief period of time, to allow a creditor sufficient time to seek bankruptcy court approval to exercise its setoff rights. In In re Patterson, 967 F.2d 505 (11th Cir. 1992), a credit union "froze" a debtor's account upon receipt of notice that the debtor had commenced a case under Chapter 13 of the Bankruptcy Code. The credit union filed a proof of claim in the debtor's bankruptcy case, noting its security interest in the

debtor's account,[3] but otherwise took no action to obtain authorization to exercise its setoff rights until the debtor commenced a turnover proceeding and sought an injunction against the credit union. Patterson, 967 F.2d at 508.

The Patterson court held that the credit union, while validly concerned that the debtor might dissipate the collateral against which it sought to exercise its right of setoff, was required to act promptly to preserve the funds:

> The Credit Union's underlying concern is not frivolous, however. The Credit Union froze the Pattersons' accounts to avoid paying the Pattersons' checks, which would dissipate the Credit Union's collateral on its loan to the Pattersons. If the Credit Union's right to setoff were later determined valid, and if the funds in the account had been disbursed to payees, the Credit Union's right to setoff would indeed be an empty right. See In re Edgins, 36 B.R. 480, 484 (Bankr. 9th Cir. 1984) ("This will, all too often, be an attempt to lock the barn door after the horse has been stolen.").
>
> * * *
>
> Creditors in this position have an alternative remedy and need not freeze debtors' accounts. The creditor may file an ex parte motion pursuant to Sections 362(f) or 363(e) and accompany this motion with the funds from the debtors' account to be paid into the registry of the bankruptcy court.

Patterson, 967 F.2d at 510-11. In short, the Eleventh Circuit does allow a creditor to decline to honor checks drawn on a debtor's account, albeit briefly, to provide the creditor the ability to

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[3] As discussed, infra, at 26-27, the Bankruptcy Code treats a creditor holding a right of setoff as a secured creditor under § 506 of the Bankruptcy Code.

obtain court authority to exercise the right of setoff.[4]

The Fifth Circuit also has held that a creditor may refuse to honor a debtor's demand to turn over funds of the estate pending determination of such creditor's right of setoff, without incurring penalty or other sanction by the bankruptcy court. In In re Davis, 889 F.2d 658 (5th Cir. 1989), cert. denied sub nom., Campbell v. United States, 495 U.S. 933 (1990), the debtor moved under § 502(b) of the Bankruptcy Code to disallow a claim filed by a creditor, the Internal Revenue Service, on the ground that the IRS had refused to honor the debtor's demand to turn over a tax refund due to the debtor. The Fifth Circuit

[4] By contrast, the Fourth Circuit's approach permits no opportunity for a bank creditor to protect its setoff rights.

concluded that the IRS permissibly declined to pay the refund to the debtor pending resolution of the IRS's claim for penalty and interest, against which claim the IRS might have offset the refund due the Debtor. Id. at 663.

The resolution of the conflict between the Third, Fourth and Eighth Circuits, on the one hand, and the Eleventh and Fifth Circuits, on the other, will aid the lower courts immensely in administering provisions of the Bankruptcy Code governing a basic and important issue which arises repeatedly in bankruptcy cases. The Court need not tolerate division and uncertainty on a question so fundamental as whether a creditor must pay to the debtor monies which are the collateral of the creditor and otherwise are subject to the right of

setoff, before the creditor can obtain authorization from the bankruptcy court to exercise its right of setoff, thereby defeating any meaningful exercise of such right.

B. The District Courts And Bankruptcy Courts Are Also Divided On The Permissibility Of An Administrative Hold Or Freeze.

There is similar division among the lower courts as to whether a creditor may place an administrative hold or freeze on the funds of a debtor, in accordance with the creditor's rights under § 542 of the Bankruptcy Code, while the creditor seeks relief from the automatic stay. Four of six district courts, as well as the Bankruptcy Appellate Panel for the Ninth Circuit, have held that the use of an administrative hold or freeze is permissible. See In re Edgins, 36 B.R.

480, 485 (Bankr. 9th Cir. 1984); Air Atlanta, Inc. v. Nat'l Bank of Georgia, Inc., 81 B.R. 724, 726 (N.D. Ga. 1987); Rio v. Army Aviation Center Fed. Credit Union, 82 B.R. 138, 144 (M.D. Ala. 1986); Stann v. Mid. Am. Credit Union, 39 B.R. 246, 249 (D. Kan. 1984); Kenney's Franchise Corp. v. Cent. Fidelity Bank, N.A., 22 B.R. 747, 750 (W.D. Va. 1982).

Two district courts have held otherwise. Sousa v. Bank of Newport, 170 B.R. 492, 494 (D.R.I. 1994); Cusanno v. Fidelity Bank, 29 B.R. 810, 813 (E.D. Pa. 1983), vacated without opinion, 734 F.2d 3 (3rd Cir. 1984). See also In re New York City Shoes, Inc., 78 B.R. 426, 432 (Bankr. E.D. Pa. 1987) (freeze not permissible except under certain circumstances). Neither of the two decisions disallowing the freeze

discussed the impact of § 542(b) of the Bankruptcy Code on the issue.

Among bankruptcy courts, similar confusion exists, with a strong majority of courts holding that the implementation of an administrative hold or freeze is permissible. See In re Moreira, 173 B.R. 965, 967 (Bankr. D. Mass. 1994); In re Lough, 163 B.R. 586, 589 (Bankr. D. Idaho 1994); In re Pimental, 142 B.R. 26, 29 (Bankr. D.R.I. 1992); In re Briggs, 143 B.R. 438, 454 (Bankr. E.D. Mich. 1992); In re Air Atlanta, 74 B.R. 426, 427 (Bankr. N.D. Ga. 1987), aff'd, 81 B.R. 724 (N.D. Ga. 1987); In re Crispell, 73 B.R. 375, 380 (Bankr. E.D. Mo. 1987); In re R.H. Williams , 61 B.R. 567, 576 (Bankr. N.D. Tex. 1986); In re Hoffman, 51 B.R. 42, 46 (Bankr. W.D. Ark. 1985);

In re Carpenter, 14 B.R. 405, 408 (Bankr. M.D. Tenn. 1981).

A minority of bankruptcy courts have held that a freeze is not permitted. See In re Rio, 55 B.R. 814, 819 (Bankr. M.D. Ala. 1985), rev'd, 82 B.R. 138, 144 (M.D. Ala. 1986) (administrative hold is a freeze); In re LHG Resources, Inc., 34 B.R. 202, 204 (Bankr. W.D. Tex. 1983); In re Cusanno, 17 B.R. 879, 882 (Bankr. E.D. Pa. 1982), aff'd, 29 B.R. 810, (E.D. Pa. 1983), vacated without opinion, 734 F.2d 3 (3rd Cir. 1984) (freeze is setoff); In re Executive Assocs. Inc., 24 B.R. 171, 172 (Bankr. S.D. Tex. 1982) (freeze tantamount to setoff).

Even absent a conflict among the circuit courts of appeals on the narrow issue of the permissibility of an administrative hold while a creditor

seeks authorization to exercise its right of setoff, the Court may grant certiorari to rectify such widespread confusion among lower courts on an issue as important and basic as that presented here. See Dawson Chemical Co. v. Rohn & Haas, Co., 448 U.S. 176, 185 (1980) (certiorari granted to forestall possible conflict on issue of "prime importance" in patent law, even though no direct conflict existed among circuit courts of appeals). Countless bankruptcy cases involve a debtor having funds on deposit with a bank to which the debtor owes money. Whether the debtor may eliminate the bank's setoff rights and defeat its security interest by demanding the withdrawal of the deposit funds before the bank can obtain a bankruptcy court order authorizing a setoff presents a

fundamental issue concerning postbankruptcy petition relations between debtors and creditors. Resolving this issue now would serve to end repeated litigation and to create certainty with respect to one of the most basic aspects of debtor-creditor relations.

II. THE LOWER COURT'S RULING HAS SEVERAL SERIOUS NEGATIVE PRACTICAL IMPLICATIONS.

The result in Strumpf will negatively impact the manner in which debtors and bank creditors approach bankruptcy cases. From a creditor's perspective, Strumpf creates an enormous incentive on the part of a bank creditor to accomplish setoff before the prospective debtor files a bankruptcy petition. Under normal circumstances, a creditor's exercise of its right of setoff before the commencement of a

bankruptcy case is not subject to attack as a preference, or otherwise subject to any of the "avoidance" powers set forth in §§ 544, 545, 547, 548 and 550 of the Bankruptcy Code.

Moreover, once a bankruptcy case is filed, creditors will be compelled repeatedly to initiate ex parte litigation and to request emergency hearings. Indeed, the Fourth Circuit openly advocated that creditors file ex parte motions for relief from the stay if the creditor wishes to avoid losing its security (i.e., the debtor's funds on deposit with the bank), but does not wish to violate the automatic stay. See Strumpf, 37 F.3d at 159. Unfortunately, in the case of a request by the debtor to withdraw funds from a demand account "at the counter", even ex parte relief will

be of no avail. See In re Moreira, 173 B.R. at 968.

In the Eleventh Circuit, the Patterson opinion requires a bank which receives a draft on the debtor's checking account to seek emergency relief and pay the funds to the registry of the court by midnight of the date on which the debtor's check drawn on the account subject to setoff rights is presented. 967 F.2d at 511.

Absent the view adopted below, there would be absolutely no need for such emergency litigation. A motion for relief from the automatic stay must, under the express terms of § 362(e) of the Bankruptcy Code, be concluded within sixty days of its filing. If a bank creditor files such a motion concurrently with the institution of a freeze on the

debtor's account, a speedy resolution is required by the Bankruptcy Code. Denial of the writ of certiorari will condemn creditors to file "emergency" motions routinely, burdening the courts and hampering administration of the bankruptcy laws.

III. A BANK CREDITOR SHOULD NOT BE REQUIRED TO DISBURSE FUNDS FROM AN ACCOUNT OF ITS DEBTOR, PARTICULARLY WHERE THE CREDITOR MOVES PROMPTLY FOR AUTHORIZATION TO EXERCISE ITS SETOFF RIGHTS.

A. The Lower Court's Opinion Disturbs The Statutory Balance Between A Creditor's Right Of Setoff And A Debtor's Need To Preserve And Use Accounts.

Whether Citizens could properly defer Strumpf's demand to withdraw funds from his bank account pending determination of Citizens' right of setoff requires consideration of the interplay between no fewer than five different sections of the Bankruptcy

Code. The Fourth Circuit's opinion regrettably focused on only one, 11 U.S.C. § 362(a)(7). In doing so, the Court ignored the impact of §§ 363(a), 506(a), 553, and 542(b).

A creditor with a right of setoff under state law is treated as a secured creditor under the Bankruptcy Code pursuant to the express terms of § 506(a). Indeed, Citizens' security is treated as "cash collateral" pursuant to the terms of § 363(a).[5] Thus, "[A] bank stayed from setting off under § 362(a)(7) would be treated as the holder of a secured claim under § 506(a) to the

[5] Although the Fourth Circuit's opinion makes a passing reference to § 506(a) in a footnote, the Court did not examine in any way the consequences which flow from the fact that Citizens was a secured creditor of Strumpf and that Citizens' collateral is treated as cash collateral under the Bankruptcy Code. See Strumpf, 37 F.3d at 157 n.*.

extent of a deposit amount, and the deposit account is considered 'cash collateral' under § 363(a)." 2 James W. Moore & Lawrence P. King, Collier on Bankruptcy ¶ 363.02 (15th ed. 1994). In turn, the Bankruptcy Code provides that cash collateral cannot be used by a debtor unless the creditor secured by such collateral consents or unless the bankruptcy court first enters an order authorizing such use. See 11 U.S.C. § 363(c)(2).

In this case, Strumpf violated the express terms of § 363(c)(2) by withdrawing and using Citizens' cash collateral without Citizens' consent and without an order from the bankruptcy court authorizing such use. Indeed, the Fourth Circuit's opinion will no doubt be viewed by other debtors and their counsel

as a license to flout the rights of creditors with liens in cash collateral otherwise protected by the Bankruptcy Code.

In order to protect Citizens' rights as a secured creditor, the Bankruptcy Code expressly authorizes Citizens to withhold the funds due Strumpf pursuant to § 542(b) of the Code. That section requires that entities which owe a debt to the debtor that is matured, payable on demand or payable on order, must pay the debt to the trustee, "except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor." 11 U.S.C. § 542(b) (emphasis supplied).

The administrative hold placed on a debtor's account by a bank is nothing more than the mechanism by which the bank

communicates its decision to exercise its rights under § 542(b) to multiple branches, automated teller machines, and other actors with responsibility for administering bank accounts. Thus, an administrative hold precluding the debtor's access to funds in an account pending determination of a bank's right of setoff is "recognized and countenanced by 11 U.S.C. § 542(b). . . ." In re Edgins, 36 B.R. at 483.

The foregoing restrictions upon the exercise of the right of setoff by the creditor, on the one hand, and on the use by the debtor of such creditor's cash collateral, on the other, gives rise to a purposeful statutory equilibrium described by the Bankruptcy Appellate Panel for the Ninth Circuit as a "stalemate":

> This stalemate may be alleviated by either party initiating a number of alternative proceedings in the Bankruptcy Court.
>
> * * *
>
> The creditor might bring an action for relief from the automatic stay for the purpose of asserting and exercising its security interest and right to setoff. The debtor might bring a motion for use of the security as cash collateral under 11 U.S.C. § 363. Any of these motions could be pursued by a motion and in a shortened time frame, given an emergency. The Bankruptcy Code does not specify which should be used nor whether the creditor or the debtor should initiate the action to break the statutory log jam.

In re Edgins, 36 B.R. at 483.[6]

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[6] A bank lender's inability to effectuate a setoff without violating the automatic stay has also been referred to as the "banker's dilemma." In re Bass Mechanical Contractors, Inc., 84 B.R. 1009, 1022 (Bankr. W.D. Ark. 1988).

Because the court below failed to consider several relevant statutes, the result reached was predictable:

> The Bankruptcy Code is a complex web often requiring the reconciliation of numerous sections to arrive at a determination of rights. The seemingly uncomplicated question or whether a bank owed money by its customer may temporarily freeze the customer's account upon learning of its bankruptcy cannot be answered adequately without considering the interplay of several Code provisions. When only Sections 553(a), recognizing the right of setoff, and 362(a)(7) applying the automatic stay to setoff, are considered, an erroneous conclusion is reached which prohibits the freezing of funds without court approval.

B. Weintraub & A. Resnick, Freezing the Debtor's Account: A Banker's Dilemma Under The Bankruptcy Code, 100 Banking L.J. 316, 324 (1983).

B. The Fourth Circuit's Opinion Reflects A Misunderstanding Of The Relationship Between The Depositor And The Bank.

The Fourth Circuit's failure to apply § 542(b) of the Bankruptcy Code[7] may be based upon a misapprehension of the nature of the debtor's "account" at Citizens. Although it is common for depositors and others to misperceive a "bank account" as the equivalent of a safe deposit box in which the depositor's funds are placed and held by the bank, the legal relationship between a depositor and the depository financial institution is that of creditor and debtor:

> It may be said generally that the relation of a bank and

[7] The Fourth Circuit's opinion mentions § 542(b) of the Bankruptcy Code in a footnote, but fails to recognize the significance of § 542(b) to this case. See Strumpf, 37 F.3d at 157 n.*.

> depositor is that of debtor and creditor; the money deposited is regarded as a loan to the bank by the depositor, with the right of the depositor to draw on it to the extent of the deposit.

Keller v. Fredericktown Sav. Inst., 66 A.2d 924, 925 (Md. 1949). See also Taylor v. Equitable Trust Co., 304 A.2d 838, 842 (Md. 1973); Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold, 608 A.2d 1194, 1201 (Md. App. 1992).

Under the terms of § 542(b) of the Bankruptcy Code, Citizens was not required to honor Strumpf's demand for payment of the "debt" owed by Citizens to Strumpf, pending determination of Citizens' setoff rights. The Fourth Circuit's holding to the contrary, eviscerating the protection afforded to Citizens by § 542(b) of the Bankruptcy

Code, appears to be a result of the Fourth Circuit's failure to recognize that Strumpf's deposit account at Citizens was a debt within the ambit of § 542(b). In essence, the holding below effectively denies to bank creditors the same right to withhold payment of funds subject to a claim of setoff which is available to virtually every other class of creditors.

C. The Court's Opinion Ignores Settled Law That The Right Of Setoff Must Be Respected, And Incorrectly Suggests That § 362(a)(7) Was Intended By Congress To Defeat The Right Of Setoff.

The Fourth Circuit's decision wrongly suggests that Congress intended a debtor to have the ability to defeat a creditor's right of setoff by moving quickly to withdraw funds or otherwise enforce the debtor's rights against the

creditor, before the creditor can obtain relief from the automatic stay. In the words of the Fourth Circuit: "While the banker's dilemma may allow a debtor to defeat a creditor's right of setoff, the clear and unambiguous language of § 362(a) produces this result". Strumpf, 37 F.3d at 159. As noted above, the Fourth Circuit reached an erroneous conclusion by focusing on only one of five different statutory provisions governing the right of setoff.

Moreover, the court's opinion disregards well-developed law concerning the right of setoff. As a threshold matter, a presumption exists in favor of the enforcement of the right of setoff. In re De Laurentiis Entertainment Group, Inc., 963 F.2d 1269, 1277 (9th Cir. 1992), cert. denied, ___ U.S. ___, 113 S.

Ct. 330, 121 L. Ed. 2d 249 (1992). Furthermore, there are but two circumstances under which a right of setoff may be denied to a creditor with mutual claims owed by and to a debtor. First, setoff has been denied where a creditor is overcollateralized or otherwise adequately protected. See, e.g., In re American Sunlake Ltd. Partnership, 109 B.R. 727, 737 (Bankr. W.D. Mich. 1989) (setoff not permitted where creditor adequately protected by equity cushion in real estate collateral). Second, a creditor may lose its setoff right when it has engaged in inequitable conduct. See, e.g., In re Cascade Roads, Inc., 34 F.3d 756, 762-66 (9th Cir. 1994) (setoff denied where creditor "stonewalled" debtor during receivable litigation).

This case does not fall within either of these two exceptions to the presumptive enforceability of the right of setoff. Citizens was protected by no other collateral of Strumpf, and Strumpf has made no showing that the Chapter 13 trustee had sufficient funds to pay Citizens. Nor is it suggested that Citizens committed misconduct of any kind which would justify denying its right of setoff. Indeed, the bankruptcy court below ultimately held that Citizens was entitled to exercise this right. Unfortunately, because the bankruptcy court had previously held that the administrative hold constituted a violation of the automatic stay and thus required Citizens to release all of the deposit funds, its ruling came too late,

leaving Citizens with a right of setoff but a hollow remedy.

The doctrine of setoff was grounded on the absurdity of making A pay B when B owes A. See Strumpf, 37 F.3d at 157 (citations omitted). Under the rule enunciated by the court below, that absurdity becomes reality, resulting in the virtual elimination of banks' and other creditors' time honored right of setoff.

D. The Court's Decision Incorrectly Equates A Setoff With A Bank's Temporary Refusal To Comply With A Debtor's Demand To Withdraw Funds.

Fundamental to the Fourth Circuit's decision was the conclusion that Citizens' refusal to honor the Strumpf's demand to withdraw funds was itself a setoff in violation of the automatic stay. This conclusion is contrary to

well-developed law governing precisely when a setoff has occurred.

Because the timing of a setoff often is crucial to establish priorities among competing creditors,[8] the law has developed a precise test to determine just when a setoff has actually occurred. In the leading case of Baker v. Nat'l City Bank of Cleveland, 511 F.2d 1016 (6th Cir. 1975), a bank attempted to argue that setoff of a bankrupt depositor's account had been accomplished before an order issued from the bankruptcy court staying the exercise of such right. The court disagreed:

> [T]he act of setoff is not complete until three steps have been taken: (i) the decision to exercise the right; (ii) some action which accomplished the setoff; and (iii) some record which evidences that the right of setoff has been recognized.

Baker, 511 F.2d at 1018. Accord United States v. Central Bank of Denver, 843 F.2d 1300, 1310 (10th Cir. 1988); In re Saugus Gen. Hosp., Inc., 698 F.2d 42, 47-48 (1st Cir. 1983). Indeed, the statutory "log jam" described in Edgins, supra, implicitly recognizes that there is a significant distinction between withholding payment to the debtor of funds which may be subject to the rights of setoff and the actual exercise of the setoff right. In re Carpenter, 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981).

In this case, Citizens did not debit Strumpf's account, or take any other steps to complete the setoff of Strumpf's

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[8] Priority among competing creditors with respect to depository accounts, including the depository institution itself as a creditor with right of setoff, is governed by § 4-303 of the Uniform Commercial Code. See Md. Comm. Law I Code Ann. § 4-303 (1992 Repl. vol.).

debt against the funds in Strumpf's account. Citizens clearly did not take all of the steps under Baker and its progeny necessary to constitute the full exercise of the right of setoff, nor did it intend to. Because Citizens did not accomplish the setoff against Strumpf's account, it did not violate § 362(a)(7) of the Bankruptcy Code.

CONCLUSION

Citizens respectfully requests that the Court grant this Petition for Writ of Certiorari.

Respectfully submitted,

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IN THE

Supreme Court of the United States

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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APPENDIX A

In Re: DAVID STRUMPF, Debtor.

CITIZENS BANK OF MARYLAND,
Plaintiff-Appellee,

v.

DAVID STRUMPF, Defendant-Appellant.

No. 92-1519

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

37 F.3d 155

February 2, 1993, Argued
October 13, 1994, Decided

COUNSEL: Argued: John Randall Owen, Jr., JOHN R. OWEN, JR. & ASSOCIATES, P.C., Hyattsville, Maryland, for Appellant.

Argued: Matthew A. Egeli, HARTMAN & CRAIN, Annapolis, Maryland, for Appellee.

On Brief: C. Edward Hartman, III, HARTMAN & CRAIN, Annapolis, Maryland, for Appellee.

JUDGES: Before RUSSELL and WIDENER, Circuit Judges, and CHAPMAN, Senior Circuit Judge. Judge Widener wrote the opinion, in which Judge Russell and Senior Judge Chapman concur.

WIDENER, Circuit Judge:

This case presents an issue of first impression on the same facts in the courts of appeal, although the Third and Eighth Circuits have considered similar fact situations, as have we. It is whether a bank violates the automatic stay of 11 U.S.C. § 362(a) by placing an administrative hold on a debtor's account while seeking relief from the stay to exercise its right of setoff. The United States Bankruptcy Court for the District of Maryland held Citizens Bank of Maryland (Citizens) in contempt for violating the automatic stay and awarded damages to Strumpf under 11 U.S.C. § 362(h). See Citizens of Md. v. Strumpf, 138 B.R. 792 (D. Md. 1992). On appeal, the United States District Court for the District of Maryland reversed. See 138

B.R. at 795. Strumpf now appeals and we reverse.

I.

On November 28, 1989, Citizens loaned Strumpf $5,068.75 on a note as an unsecured consumer loan to be repaid in 24 monthly installments. See 138 B.R. at 792. Upon default, the note provided Citizens with the right to immediately accelerate the amount due, the right to recover attorney's fees incurred in collection, and the right of setoff. See 138 B.R. at 792. On January 25, 1991, Strumpf filed a Chapter 13 bankruptcy petition. See 138 B.R. at 792. At the time of filing, Strumpf had $11,279.86 in a checking account with Citizens, and the note was in default because Strumpf had failed to make scheduled payments. See 138 B.R. at 792. On March 20, 1991, the

bankruptcy court confirmed Strumpf's repayment plan.

On October 7, 1991, Citizens filed a motion for relief from the automatic stay and for setoff and placed an administrative hold on $3,500 in Strumpf's checking account, $3,250.48 being due on the note at the time. See 138 B.R. at 792-93. On October 9, 1991, Strumpf filed a motion to hold Citizens in contempt for violating the automatic stay of § 362(a). See 138 B.R. at 793. The bankruptcy court reserved ruling on Citizens' motion on November 4, 1991, and then granted Strumpf's motion on November 13, awarding him attorney's fees of $500, punitive damages of $375, and nominal damages of $25. See 138 B.R. at 793. On December 2, the bankruptcy court granted Citizens' motion for relief from the stay

and authorized it to exercise its right of setoff. See 138 B.R. at 793. Citizens, however, was unable to set off its loan because Strumpf had withdrawn all funds from his checking account after Citizens removed the administrative hold. See 138 B.R. at 793.

II.

The right of setoff may arise contractually or under state law, see 4 Collier on Bankruptcy ¶ 553.06 (15th ed. 1992), and it allows a creditor to apply one mutual debt against another to avoid "the absurdity of making A pay B when B owes A." Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528, 33 S. Ct. 806, 808, 57 L. Ed. 1313 (1913). While the Bankruptcy Code preserves a creditor's right of setoff that arose before the filing of a petition in bankruptcy, see 11 U.S.C. §

553(a), the Code stays the exercise of the right of setoff by making it subject to the automatic stay of § 362(a).* See 11 U.S.C. § 362(a)(7). To exercise its right of setoff, a creditor must obtain relief from the automatic stay by filing a motion with the bankruptcy court. See 11 U.S.C. § 362(d). If the creditor fears that the property subject to the motion will suffer irreparable damage before notice and hearing may be had, the creditor may even file an ex parte motion under § 362(f). See 11 U.S.C. § 362(f). Any relief from the automatic stay rests within the sound discretion of the

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* The Code also grants creditors with a valid right of setoff two other rights. Section 506(a) gives a creditor a secured claim to the extent of the amount subject to setoff. See 11 U.S.C. § 506(a). Section 542(b) excepts a creditor from turning over property to the debtor's estate to the extent of the setoff. See 11 U.S.C. § 542(b).

bankruptcy court. See Small Business Admin. v. Rinehart, 887 F.2d 165, 169 (8th Cir. 1989).

If the debtor learns of the motion for relief from the stay, however, the debtor may defeat the creditor's right of setoff by removing all funds in the creditor's possession before the creditor can obtain relief from the stay. Therefore, even if the creditor is granted relief from the automatic stay, the creditor will have nothing with which to set off the debt owing it. As the district court recognized, this scenario is known as the "banker's dilemma": "[W]hen a bankruptcy is filed, a bank claiming a right of set-off in a debtor's account may be faced with a dilemma - whether it should turn over proceeds of [the] debtor's account or whether it

should exercise its set-off rights in violation of the automatic stay." Citizens Bank, 138 B.R. at 702, quoting from In Re Bass Mechanical Contractors, Inc., 84 B.R. 1009, 1022 (Bankr. W.D. Ark. 1988). Recognizing this dilemma, some bankruptcy and district courts have held that pending a motion for relief from the stay, a creditor asserting a right of setoff may place an administrative hold on a debtor's account without violating the automatic stay of § 362(a). See Citizens Bank, 138 B.R. at 793 (holding same and collecting cases). Relying on this body of case law, Citizens placed an administrative hold on Strumpf's account and filed a motion for relief from the stay. See 138 B.R. at 794.

While we understand the dilemma that Citizens and other similarly situated creditors face, we cannot overlook the fact that the Code does not authorize such action, and is quite to the contrary. Setoff is explicitly within the terms of section 362(a)(7) which stays a creditor from exercising its right of setoff unless and until the creditor obtains relief from the stay. In United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985), we held that a freeze by the Internal Revenue Service (IRS) on a debtor's tax refund "was a setoff subject to the automatic stay and that the IRS violated the stay in retaining the funds." 764 F.2d at 1006-07. Based on this holding, we are of opinion that an administrative hold is tantamount to the exercise of a right of setoff and thus

violates the automatic stay of § 362(a)(7). See 764 F.2d at 1006-07. As well as Rinehart, supra, United States v. Norton, 717 F.2d 767, 773 (3d. Cir. 1983) — and In Re Penn Central Transportation Company, 453 F.2d 520 (3d. Cir. 1972) (a railway reorganization under the Bankruptcy Act) are on slightly different facts but are fully in accord with our decision. Whether the creditor actually offsets the debtor's account or places a hold on the debtor's account, both effectively deprive the debtor of the use of the funds pending the outcome of the motion for relief from the stay. See Rinehart, 887 F.2d at 168.

Citizens attacks this holding, the same one reached by the bankruptcy court, claiming that Reynolds is distinguishable and that equating an administrative hold

with the exercise of the right of setoff renders the right of setoff unenforceable and effectively repeals § 553(a). Citizens states that, unlike the IRS in Reynolds, Strumpf's plan made no provision to pay Citizens as a secured creditor despite its status as a secured creditor under § 506(a). Furthermore, Citizens claims that, unlike the IRS, it did not intend to keep the hold on Strumpf's account until the end of his Chapter 13 plan.

We are not persuaded by Citizens' efforts to distinguish Reynolds. While the fact that Citizens was not provided for as a secured creditor in Strumpf's plan might be taken into account in deciding whether the bankruptcy court should grant Citizens relief from the automatic stay under § 362(d)(1), it has

no bearing on whether Citizens acted properly in placing an administrative hold on Strumpf's account. We are further of opinion that the length of time a creditor intends to maintain a hold is not relevant to whether a hold is tantamount to a setoff. In Reynolds the IRS intended to hold the funds until the Chapter 13 plan was closed because the bankruptcy court had denied it relief from stay due to its status as a secured creditor with adequate protection. See 764 F.2d at 1007. In this case, Citizens intended to hold Strumpf's account only until it could get relief from stay. These cases indicate to us that the length of time a creditor intends to maintain the hold is determined by that same creditor's ability to get relief from the automatic stay and exercise its

right of setoff, so the length of time is not relevant to whether a hold is tantamount to a setoff.

We likewise are not persuaded by Citizens' claims that our holding renders the right of setoff unenforceable and effectively repeals § 553(a). Statutory construction begins with the literal language of a statute, see United States v. Turkette, 452 U.S. 576, 580, 101 S. Ct. 2524, 2527, 69 L. Ed. 2d 246 (1981), and if the language is clear and unambiguous our task is at an end unless a literal reading of the statute contravenes the clearly expressed legislative intent of Congress. See Russello v. United States, 464 U.S. 16, 20, 104 S. Ct. 296, 299, 78 L. Ed. 2d 17 (1983). While the banker's dilemma may allow a debtor to defeat a creditor's

right of setoff, the clear and unambiguous language of § 362(a) produces this result. Furthermore, our holding does not contravene any clearly expressed legislative intent of Congress:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

House Report No. 95-585, 95th Cong., 1st Sess. 340-2 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 54-55 (1978); reprinted in 1978 U.S.C.C.A.N. 5787 at 5840 and 6296-7. "If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful

rehabilitation would be substantially diminished." See Reynolds, 764 F.2d at 1007 (quoting Norton, 717 F.2d at 773).

III.

As for the bankruptcy court's award of attorney's fees, punitive damages, and nominal damages, we are of opinion that such an award was appropriate and not an abuse of discretion. See Budget Service Co. v. Better Homes of Va., 804 F.2d 289, 292-93 (4th Cir. 1986). To award damages under § 362(h) the bankruptcy court need only find a willful violation of the automatic stay of § 362(a). To constitute a willful act, the creditor need not act with specific intent but must only commit an intentional act with knowledge of the automatic stay. See Budget Service, 804 F.2d at 292-293; In Re Atl. Business & Community Corp., 901 F.2d 325, 329 (3d

Cir. 1990). In this case there is no doubt that Citizens had knowledge of the stay when it placed the hold on Strumpf's account because the placing of the hold was an attempt to buy time while seeking relief from the automatic stay.

IV.

We are thus of opinion that Citizens' administrative hold on Strumpf's account violated the automatic stay provisions of § 362(a)(7) and that the bankruptcy court did not abuse its discretion by finding Citizens had violated the automatic stay and awarding damages.

Accordingly, we reverse the decision of the district court and remand with instructions to reinstate all of the decision of the bankruptcy court except that part which may have held Citizens in

contempt of court. That part of the decision of the district court with reference to holding Citizens in contempt of court is not appealed by Strumpf (Brief, p.7-8), although that part finding Citizens had not violated § 362(a)(7) and not awarding damages under § 362(h) was appealed. In all events, the finding of contempt was surplusage. See Budget Service Company, 804 F.2d 289, 293, and n.4.

REVERSED AND REMANDED WITH INSTRUCTIONS

APPENDIX B

CITIZENS BANK OF MARYLAND, Appellant

v.

DAVID STRUMPF, Appellee

Civil No. HAR-91-3692

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

138 B.R. 792

March 27, 1992, Decided
March 30, 1992, Filed

COUNSEL: Attorney for Appellant, C. Edward Hartman, III, Annapolis, MD 21401.

Attorney for Appellee, John R. Owen, Jr., Hyattsville, MD 20782.

JUDGES: Hargrove

MEMORANDUM OPINION

Currently before this Court is Citizens Bank of Maryland's ("Citizen's Bank") appeal from the United States Bankruptcy Court for the District of Maryland. The issues have been fully

briefed, and no hearing is deemed necessary.

The first issue presented to this Court is whether the Bankruptcy Court erred as a matter of law in holding that the Appellant violated the automatic stay of 11 U.S.C. § 362(a) when it placed an administrative hold on the Appellee's checking account pending the Bankruptcy Court's disposition of the Appellant's Motion for Relief from Automatic Stay and for Setoff. The second issue before this Court is whether the Bankruptcy Court erred in finding the Appellant in contempt and assessing attorney's fees, punitive damages, and nominal damages under 11 U.S.C. § 362(h).

FACTS

Citizens Bank loaned Strumpf $5,068.75 pursuant to an unsecured

consumer loan note ("Note") on November 28, 1989. Strumpf agreed to pay off the loan (including interest) in twenty-four monthly installments. The Note provided for the immediate acceleration of the amount due upon default, and for the payment of attorney's fees upon referral of the matter to an attorney for collection. The note further provided for the right of setoff.

On January 25, 1991, Strumpf filed a Petition for Relief under Chapter 13 of Title 11, U.S.C., in the Bankruptcy Court. (Case No. 91-40389PM). At the time of the filing of the Petition, Strumpf had a checking account with Citizens Bank, containing $11,279.86. Because Strumpf had failed to make scheduled payments, Citizens Bank declared the Note in default.

On October 7, 1991, Citizens Bank filed a Motion for Relief from Automatic Stay and for Setoff against Strumpf. In the Motion, Citizens Bank sought permission to setoff the amounts owed on the Note against the amounts then in Strumpf's checking account. Simultaneous with filing the Motion for Relief from Automatic Stay and for Setoff, Citizens Bank placed an administrative hold on $3,500 in Strumpf's checking account,[1] pending a ruling by the Bankruptcy Court on the Motion. Citizens Bank took this action to prevent Strumpf from removing funds to which Citizens Bank claimed a setoff right.

On October 9, 1991, Strumpf filed a Motion to hold Citizens Bank in contempt

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[1] The amount due on the Note as of that date, including attorney's fees, was $3,250.48.

for violation of the automatic stay of 11 U.S.C. § 362(a), when it placed the administrative hold on the checking account. On November 4, 1991, the Bankruptcy Court, Judge Paul Mannes presiding, held a hearing on Citizens Bank's Motion for Relief from Automatic Stay and for Setoff, and reserved ruling on the Motion. On November 13, 1991, Judge Mannes held a hearing on Strumpf's Contempt Motion, granted the Motion, and ordered Citizens Bank to pay counsel fees of $500.00, punitive damages of $375.00, and nominal damages of $25.00. This ruling was set forth in a written Order on November 21, 1991.

Later, in a written Order entered December 2, 1991, Judge Mannes granted Citizens Bank's Motion for Relief from Automatic Stay and Setoff. Citizens Bank,

in compliance with Judge Mannes contempt ruling, had lifted the administrative hold on the checking account. Before the granting of Citizens Bank's Motion for Relief from Automatic Stay and Setoff, Strumpf had removed all funds from the checking account.

I.

Citizens Bank cites a substantial body of persuasive caselaw for the proposition that a bank's placing of an administrative hold on a debtor's account pending the disposition of a motion asserting the bank's right of setoff is not a violation of the automatic stay. See e.g., Bank of America Nat'l Trust & Sav. Ass'n v. Edgins, 36 B.R. 480 (9th Cir. Bankr. App. 1984); Rio v. Army Aviation Center Fed. Credit Union, 82 B.R. 138 (M.D. Ala. 1986); Stann v. Mid.

Am. Credit Union, 39 B.R. 246 (D. Kan. 1984); In re Archer, 34 B.R. 28 (B.C. N.D. Tex. 1983); In re Bass Mechanical Contractors, Inc., 84 B.R. 1009 (Bankr. W.D. Ark. 1988); Kenney's Franchise Corp. v. Cent. Fidelity Bank, NA, 22 B.R. 747 (W.D. Va. 1982); In re Williams, 61 B.R. 567 (Bankr. N.D. Tex. 1986); In re Hoffman, 51 B.R. 42 (Bankr. W.D. Ark. 1985); In re Gazelle, Inc., 17 B.R. 617 (Bankr. W.D. Wis. 1982); and In re Carpenter, 14 B.R. 405 (Bankr. M.D. Tenn. 1981).

The notion of the "banker's dilemma" supports the argument that banks have a right to place an administrative hold on a debtor's account pending further disposition of the funds:

> [W]hen a bankruptcy is filed, a bank claiming a right of set-off in a debtor's account may be faced with a

> dilemma--whether it should turn over proceeds of [the] debtor's account or whether it should exercise its set-off rights in violation of the automatic stay. To avoid this dilemma, many courts have allowed banks to place an "administrative freeze" on a debtor's account pending further disposition of the funds without violating the automatic stay. The placing of an administrative freeze on a debtor's account offers a way to preserve the debtor's account and is not a direct or indirect attempt to improve the bank's right to a distribution of assets.

Citizens Bank found itself in precisely this banker's dilemma until it placed an administrative hold on the debtor's account. Citizens Bank was not exercising its right of setoff without obtaining prior relief from the automatic stay--rather, it was acting to preserve the debtor's account until the Bankruptcy Court ruled on the Motion for Relief from Automatic Stay.

The Bankruptcy Court relied on the cases of United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985), and United States v. Norton, 717 F.2d 767 (3rd Cir. 1983), in holding that Citizens Bank's placing of an administrative hold on Strumpf's checking account was a violation of the automatic stay. Citizens Bank argues, however, that both Reynolds and Norton, are distinguishable from the case at bar. First, in those cases the Courts held that the United States, as a creditor, was not entitled to setoff income tax deficiencies which were scheduled to be paid in the debtors' confirmed Chapter 13 reorganization plans. In the case at bar, no provision was made in Strumpf's Chapter 13 plan to pay Citizens Bank's claim as a secured creditor. As such, the reorganization

plan did not provide "adequate protection" for the Bank's security interest.

More importantly, in both Reynolds and Norton, the United States intended to hold the frozen funds until the Chapter 13 cases were closed. As such, the Courts viewed the retention of funds by the IRS as the equivalent of a setoff. In the case at bar, by contrast, the administrative hold was merely designed to hold the funds until the Bankruptcy Court ruled on the disposition of the funds. Had Citizens Bank sought to retain the funds without court approval until the entire Bankruptcy proceeding was closed, it would appear that the Bank was using the funds as a setoff, in violation of the automatic stay. However, Citizens Bank, upon finding itself in the banker's

dilemma, acted reasonably by simply freezing the checking account funds only until the Bankruptcy Court ruled on its Motion for Relief from Automatic Stay and for Setoff.[2]

Further, it is noteworthy that in the case of Craddock-Terry Shoe Corp. v. Crestar Bank, 91 B.R. 392 (Bankr. W.D. Va. 1988), a case from the same district as Reynolds, the Court held, relying on

---

[2] The Court in Reynolds addresses the concern that by unilaterally freezing funds, "the funds would become unavailable for distribution to other creditors or for use by the debtor in a Chapter 13 plan, thus making it much less likely that the debtor could be rehabilitated." Id. at 1007. The Court notes that this problem would occur if the bank were using the money in the account for setoff without the authority of the Bankruptcy Court. In the case at bar, however, the Bank was merely awaiting instructions from the Bankrutpcy Court, and obviously needed to freeze the funds such that the ultimate ruling of the Bankruptcy Court on the Bank's Motion could be carried out. As soon as the Bankruptcy Court ruled on the Bank's Motion, the Bank could have either lifted the freeze or exercised its setoff rights, as directed by the Bankruptcy Court.

Kenney's Franchise Corp. v. Cent. Fidelity Bank, 22 B.R. 747 (W.D. Va. 1982), that a bank's action in placing an administrative freeze on a debtor's account pending the resolution of its right of setoff was not a violation of the automatic stay.

Citizens Bank argues that it was relying on the substantial body of caselaw supporting its right to place an administrative hold on Strumpf's checking account pending the Bankruptcy Court's resolution of the Motion for Relief from Automatic Stay and for Setoff. In ruling that the administrative hold violated the automatic stay, the Bankruptcy Court effectively extinguished the Bank's right to setoff because, by the time the Motion for Relief from Automatic Stay and for Setoff was ruled upon, the Bank no longer

possessed any of Strumpf's money. Citizens Bank asserts that the Bankruptcy Court's ruling effectively rendered the common law right of setoff unenforceable.

The Bankruptcy Court ruled on the Contempt Motion prior to ruling on the Motion for Relief from Automatic Stay and for Setoff. The ironic result for Citizens Bank was that it was held in Contempt, was later granted its Motion for Relief from Automatic Stay and for Setoff, but could not exercise its right to setoff because (as predicted by Citizens Bank) Strumpf had removed the money from the checking account. This series of events rendered the Bankruptcy Court's ultimate granting of Citizens Bank's Motion meaningless.

The Court finds that the placing of an administrative hold on an account

pending the Bankruptcy Court's ruling on the Bank's Motion for Relief from Automatic Stay and for Setoff does not equate to a setoff as a matter of law. In fact, permitting the Bank to freeze the funds until such time as the Court rules on the Bank's Motion for Relief from Automatic Stay and for Setoff is the only sensible procedural approach under these circumstances.

II.

Given the existing law supporting the Bank's right to freeze the account, and given the "catch-22" nature of the circumstances for the Bank in this case, it would be patently unfair to uphold the Bankruptcy Court's finding of contempt. Citizens Bank has noted that the issue of whether a bank may impose an administrative hold on a debtor's

checking account has not been addressed by this Court in a published decision, and that any ambiguity in the law should be resolved in favor of the party charged with contempt. Int'l Brotherhood of Teamsters, etc. v. W. Pa. Motor Carriers Ass'n, 660 F.2d 76, 82 (3rd Cir. 1981). In any event, the Court agrees with Citizens Bank's interpretation of the applicable law, and as such, the Bankruptcy Court's finding of contempt cannot be upheld. Accordingly, the Bankruptcy Court's finding of contempt and assessment of attorney's fees, punitive damages, and nominal damages against Citizens Bank under 11 U.S.C. § 362(h) must be reversed. It will be so ordered.

3/27/92 Date

John R. Hargrove
United States District Judge

ORDER

In accordance with the foregoing Memorandum Opinion, IT IS, this 27th day of March, 1992, by the United States District Court for the District of Maryland, hereby ORDERED:

1. That the November 20, 1991 Order of the Bankruptcy Court for the District of Maryland, finding Appellant in Contempt for a violation of the automatic stay of 11 U.S.C. § 362(a), and awarding sanctions under 11 U.S.C. § 362(h), BE and the same hereby IS REVERSED.

2. That the Clerk of the Court CLOSE this case;

3. That the Clerk of the Court mail copies of this Order and the accompanying Memorandum Opinion to the Honorable Paul Mannes and all parties of record.

John R. Hargrove
United States District Judge

APPENDIX C

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND
AT ROCKVILLE

IN RE:	:
	:
DAVID STRUMPF	:
	:
Debtor	:
DAVID STRUMPF	:
	:
Movant	:
	:
vs.	:
	:
CITIZENS BANK OF MARYLAND	:
	:
Respondent	:

Case No. 91-4-0389-PM
Chapter 13

ORDER FINDING RESPONDENT IN CONTEMPT
AND AWARDING SANCTIONS

This matter is before the court upon the motion of the debtor to hold Citizens Bank of Maryland in contempt, the response of Citizens Bank, respondent, and after a hearing thereon and the court

having considered the memoranda of the parties and the arguments in open court, and the court having stated its findings of facts and conclusions of law on the record at the conclusion of the hearing, and the court finding that the action of the said respondent in placing an administrative hold on the checking account of the debtor was a violation of the automatic stay of 11 U.S.C. § 362(a), thereby entitling debtor to damages under 11 U.S.C. § 362(h), it is, this 20 day of November, 1991, by the United States Bankruptcy Court for the District of Maryland,

ORDERED That the debtor is allowed counsel fees for the prosecution of the contempt action in the sum of $500.00; and it is further

ORDERED That the debtor is allowed punitive damages in the sum of $375.00 against the respondent; and it is further

ORDERED That debtor is allowed nominal damages in the sum of $25.00; and it is further

ORDERED That payment of all the foregoing is to be made by respondent to the debtor, in care of his counsel of record, on or before the 11th day of December, 1991.

/s/ Paul Mannes
Chief Judge, United States
Bankruptcy Court for the
District of Maryland

ENTERED: November 21, 1991

cc: John R. Owen, Jr.
C. Edward Hartman III
David Strumpf
Thomas Lackey

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

FILED
November 8, 1994

No. 92-1519
BK-91-4038
CA-91-3692-HAR

In Re: DAVID STRUMPF
Debtor

CITIZENS BANK OF MARYLAND

Plaintiff - Appellee

v.

DAVID STRUMPF

Defendant - Appellant

FIRST NATIONAL BANK OF MARYLAND;
NATIONSBANK OF NORTH CAROLINA, N.A.;
NATIONSBANK

Amici Curiae

On Petition for Rehearing With Suggestion
for Rehearing In Banc

The appellee's petition for rehearing and suggestion for rehearing in

banc were submitted to this Court. As no member of this Court or the panel requested a poll on the suggestion for rehearing in banc, and

As the panel considered the petition for rehearing and is of the opinion that it should be denied,

IT IS ORDERED that the petition for rehearing and suggestion for rehearing in banc are denied.

For the Court,

/s/ Bert M. Montague
CLERK

APPENDIX E

11 U.S.C. § 362

§ 362. Automatic stay

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of --

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the

debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

* * * * * * * * * *

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court,

after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than

thirty days after the conclusion of such preliminary hearing.

§ 363. Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

§ 506. Determination of secured status

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such

disposition or use or on a plan affecting such creditor's interest.

11 U.S.C. § 542

§ 542. Turnover of property to the estate

* * * * * * * * * *

(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

§ 553. Setoff

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that --

(1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title;

(2) such claim was transferred, by an entity other than the debtor, to such creditor--

(A) after the commencement of the case; or

(B)(i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent; or

(3) the debt owed to the debtor by such creditor was incurred by such creditor--

(A) after 90 days before the date of the filing of the petition;

(B) while the debtor was insolvent; and

(C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14),,[1] 365(h)(2), or

[1]So in original.

365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of--

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds

a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

Respectfully submitted,

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Supreme Court, U.S.
FILED
MAR - 9 1995
OFFICE OF THE CLERK

No. 94-1340

(3)

IN THE

Supreme Court of the United States

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Respondent's Brief in Opposition

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26 pp

QUESTIONS PRESENTED

1. Does a Bank violate the bankruptcy automatic stay provisions of 11 USC §362(a) by seizing and denying Debtor access to his checking account funds while the Bank seeks relief from the stay?

2. After a finding that the Bank had knowledge of the bankruptcy and willfully violated the automatic stay, is the awarding of nominal damages, punitive damages and attorney's fees appropriate?

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No. 94-1340

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

JURISDICTION

Jurisdiction of this Court is based on 28 USC §1254(1).

STATUTORY PROVISIONS INVOLVED

In addition to the five sections of the United States Bankruptcy Code (hereinafter "Bankruptcy Code"), 11 USC §101 et seq., stated by Citizens to be principally involved in this case; 11 USC §362(a)(3) (the text of which is set forth in Appendix E to the Petition for Writ of Certiorari) and 11 USC §362(f) (the text of which is set forth as Appendix A to this Opposition) are also significant to this case.

The five sections cited by Citizens Bank are: §362(a)(7), §363(a), §506(a), §542(b) and §553.

STATEMENT OF THE CASE

On January 25, 1991, David Strumpf (hereinafter "Debtor") filed a voluntary bankruptcy petition seeking relief under Chapter 13 of the Bankruptcy Code. At the time the petition was filed, Debtor had an unsecured personal loan with

Citizens Bank and also maintained a checking account with the same bank. Prior to Debtor's petition, Citizens had not accelerated the note nor setoff any amounts owed against Debtor's checking account.

On February 25, 1991, Citizens Bank and Debtor's other creditors were notified of the bankruptcy filing by the United States Bankruptcy Court for the District of Maryland. The notice further advised Citizens Bank and Debtor's other creditors of the bankruptcy automatic stay and that certain actions were stayed by the bankruptcy filing including "(3) any act to obtain possession of property... (7) the setoff of any debt owing to the Debtor that arose before the commencement of the case..." 11 USC §362(a).

Debtor's Chapter 13 Repayment Plan, 11 USC §1322, was confirmed, 11 USC §1325 by the United States Bankruptcy Court on March 20, 1991, without objection from Citizens Bank, 11 USC §1324, and on the recommendation of the U.S. Trustee, 11 USC §1302. The effect of confirmation is to: "bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted or has rejected the plan." 11 USC §1327(a).

On October 2, 1991, more than six months after confirmation of Debtor's Repayment Plan, and eight months after the bankruptcy petition was filed, counsel for Debtor received a letter from counsel for Citizens Bank acknowledging the bankruptcy, but stating that a hold was being placed on Debtor's checking

account while Citizens Bank sought relief from the bankruptcy stay. Citizens Bank in the Motion for Relief from Stay argued that they had a right to setoff based on Maryland common law.

The "administrative" hold put on Debtor's checking account denied Debtor access to his funds. Made it extremely difficult for Debtor to make his payments under his Chapter 13 Repayment Plan and had the effect of denying payment to all Debtor's other creditors.

Although Citizens Bank denied Debtor access to $3,500.00 of the funds in his checking account, Citizens Bank's claim was for only $3,250.48 of which $317.40 was accumulated interest from the time Debtor filed his bankruptcy petition and $382.58 was for counsel fees for filing the Motion for Relief from Automatic Stay.

The United States Bankruptcy Court granted Citizens Bank's Motion for Relief from Automatic Stay and for Setoff on December 2, 1991. However, before that ruling, on November 13, 1991, the United States Bankruptcy Court, on Debtor's motion, held Citizens Bank in contempt for violations of the automatic stay, 11 USC §362(a) when it placed a hold on Debtor's checking account. The United States Bankruptcy Judge ordered Citizens Bank to pay nominal damages of $25.00, punitive damages of $375.00 and counsel fees of $500.00. The amount of Debtor's counsel fees were stipulated to by Citizens Bank. Testimony was presented by the Debtor that Citizens Bank in denying him his funds was a great hardship and made it difficult for him to meet his ongoing expenses.

After the Court's ruling holding Citizens Bank in contempt, Citizens Bank released their hold on Debtor's funds and although Debtor was very pleased with the service he received from Citizens Bank, Debtor switched his funds to another bank. This made the granting of relief from the automatic stay meaningless to Citizens Bank.

Citizens Bank appealed the Bankruptcy Court's finding of contempt and assessment of nominal damages, punitive damages and attorney's fees. The U.S. District Court reversed stating: "permitting the Bank to freeze the funds until such time as the Court rules on the Bank's Motion for Relief from Automatic Stay and for Setoff is the only sensible procedural approach under these circumstances." In re Strumpf, 138 BR 792 (D. Md. 1992)

Debtor then appealed to the United States Court of Appeals for the Fourth Circuit, In re: Strumpf, 37 F3d 155 (4th Cir. 1994), which reversed the decision of the District Court and remanded with instructions to reinstate the Bankruptcy Court decision finding Citizens Bank violated the automatic stay (the finding of contempt was surplusage) and the awarding of nominal damages, punitive damages and attorney's fees, 37 F3d at 159.

The Court of Appeals based its ruling on the clear, unambiguous language of the Bankruptcy Code. 37 F3d at 159.

REASONS FOR DENYING PETITION FOR WRIT OF CERTIORARI

I. There is no division among the Circuit Court of Appeals that have considered the issue.

Citizens Bank cites In re Patterson, 967 F2d 505 (11th Cir., 1992)

as supporting the position that an "administrative" hold on debtor's funds does not violate the bankruptcy stay provision of 11 USC §362(a) and is, therefore, contrary to the Court of Appeals ruling in the instant case. This is not a proper interpretation.

The Patterson court stated:

> "The Credit Union violated general provisions of the automatic stay when in froze the Patterson's accounts and reduced the amount of an outstanding loan by the amount in the account. Such conduct represents a unilateral determination by the Credit Union of its right to setoff, a determination more appropriately within the province of the bankruptcy court." Id at page 514.

Citizens Bank quotes at length (pages 14 and 15 of Petition) from Patterson, but excludes from the quote the Court's statement "We disagree" In re Patterson 967 F2d at 511 (11th Cir.

1992), thus changing the meaning of the quote.

What the Patterson court suggested was an alternative to denying a debtor access to his funds is that the funds be placed into the registry of the bankruptcy court. However, in the instant case and the Patterson case it was not the fact situation before the Court that funds had been placed into the court registry. The ruling on the facts in Patterson are the same as the ruling below on this case.

The other Court of Appeals case cited by Citizens Bank as contrary to the instant case is: In re Davis, 889 F2d 658 (5th Cir. 1989), cert. denied sub nom. Campbell v. United States, 495 US 933 (1990).

The facts in Davis case involved the Internal Revenue Service having its

bankruptcy claim reduced for not turning over a tax refund as so ordered by the Bankruptcy Court. The tax refund was not paid pending an appeal by the IRS that was later withdrawn. The facts of the Davis case are, therefore, significantly different than the one in the instant case.

II. The Courts of Appeals that have considered whether an "administrative" hold violates the Bankruptcy stay provision of 11 USC §362(a) have ruled similar to the instant case

The Third Circuit Court of Appeals has held that banks cannot setoff debts against a corporate account as a matter of law during a bankruptcy reorganization without first obtaining relief from the automatic stay. In re Penn Central Transportation Co. 453 F2d 520 (3rd Circ. 1972).

The Court of Appeals for the Third Circuit stated in United States v. Norton, 717 F2d 767 (3rd Cir. 1983):

> "If a bank could freeze the Debtor's accounts upon the filing of a petition in Bankruptcy, the Debtor's chances for successful rehabilitation would be substantially diminished. (at 773)

The Fourth Circuit Court of Appeals quoted favorably from Norton in United States v. Reynolds, 764 F2d 1004 (4th Cir. 1985). The Fourth Circuit again repeated this quote in the instant case in supporting its finding. 37 F3rd at 159

III. The Apparent Split of Authority in United States Districts and the Bankruptcy Court.

Several District Courts and Bankruptcy Courts that have ruled on this

issue have reached differing conclusions.[1]

It is significant that many decisions that held it did not violate the bankruptcy automatic stay for banks to deny debtors their funds, including In re Edgins, 36 BR 480 (Bankr. 9th Cir. 1984) were decided prior to the 1984 Amendments to the Bankruptcy Code effective on July 10, 1984, in which Congress significantly strengthened 11 USC §362(a) by adding to the acts that were stayed by the filing of a bankruptcy petition "... to exercise control over the property of the estate." 11 USC §362(a)(3).

[1]An opinion which finds freezing a debtor's bank account is a violation of the bankruptcy automatic stay and gives a very good analysis of the Bankruptcy Code in In Re Patterson, 125 BR 40 (N.D. Ala. 1990) affirmed 967 F2d 1992. A contrary view is In re Edgins, 36 BR 480 (Bankr. 9th Cir. 1984) a 2 to 1 bankruptcy panel decision.

Also as previously discussed, this issue has been settled in the Third, Fourth, Eighth and Eleventh Circuit Courts of Appeal and, therefore, contrary decisions in these Circuits would be without validity.

IV. The Automatic Stay is the Cornerstone of the Bankruptcy Code.

Upon the filing of a bankruptcy petition, one of the fundamental principles of the Bankruptcy Code goes into effect. That is the automatic stay provisions of 11 USC §362(a). The automatic stay gives order to the proceedings by preserving Debtors assets and assuring that all creditors are treated alike.

Citizens Bank is arguing that they should be allowed to deny a debtor access to his checking account funds and put themselves ahead of all other of Debtor's

creditors, including debts classified as priority, secured and unsecured non-priority, 11 USC §507. Citizens Bank was only in a position to do this because Debtor was very pleased with the service he received at Citizens Bank and, therefore, chose to continue banking at Citizens Bank after his petition was filed. Debtor could have avoided Citizens Bank seizing his funds by merely withdrawing his money before his petition was filed.

Citizens Bank had several alternatives to violating the bankruptcy automatic stay. Among these would have been for Citizens Bank to object to Debtor's Repayment Plan and their treatment therein. Citizens Bank could also have waited until debtor was discharged and Debtor's bankruptcy case was closed, the bankruptcy stay

terminated, and then taken steps at that time to enforce any lien they may have had. Liens are not discharged in bankruptcy, 11 USC §362(c).

Citizens Bank could also have requested an ex parte motion. This is provided for in 11 USC §362(f) and was suggested as an alternative by the Fourth Circuit in the instant case, 37 F3d at 156.

V. The Clear Language of the Bankruptcy Code Does Not Support Citizens Bank's Argument.

Citizens Bank argues that Debtor violated 11 USC §363(c)(2) by using Citizen's "cash collateral" (Petition page 28). This section of the code clearly applies to debtors engaged in business. In the instant case, Debtor wad retired and his whole source of

income was retirement benefits and social security.

Citizens next argues that 11 USC §542(b) sanctions their actions, but again a reading of the code shows that this section is not an exception to the bankruptcy automatic stay provisions of 11 USC §362. To quote §542(b) "Except as provided in subsection (c)..." and subsection (c) states "Except as provided in section §362(a)(7)." §542(b) goes on to state "that such debt may offset under §553 of this title." The language of §553 (another section relied on by Citizens Bank) states, "Except as otherwise provided in this section and in sections 362..."

11 USC §506(a) also relied on by Citizens Bank also incorporate 11 USC §553.

Therefore, Citizens Bank's argument that "This case presents the Court with an opportunity to return the law governing setoffs in bankruptcy cases to the carefully balanced statutory framework established by Congress in the Bankruptcy Code," is not supported by the clear language of the Bankruptcy Code.

VI. <u>Conclusions</u>.

Debtor prays that the Court deny the Petition for Writ of Certiorari because:

1. There is no split of authority among the United States Courts of Appeals that have considered this issue, and

2. There is not the apparent split of decisions in the United States District Courts and Bankruptcy Courts in light of the 1984 Amendments that strengthen the Bankruptcy Automatic Stay, 11 USC §362(a). Also, this issue has

been settled in the Third, Fourth, Eighth and Eleventh Circuit Courts of Appeal, making opinions to the contrary invalid, and

3. The literal language of the statute does not support Citizens Bank's argument that it does not violate the bankruptcy automatic stay provision of the Bankruptcy Code to seize and deny a debtor access to his checking account funds.

Respectfully submitted,

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APPENDIX A

11 USC 362(f)

(f) Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

No. 94-1340

Supreme Court, U.S.
FILED
MAR 8 - 1995
OFFICE OF THE CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND, PETITIONER

v.

DAVID STRUMPF

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether the creditor of a debtor in bankruptcy may withhold payment of a debt it owes to the debtor while the creditor seeks relief from the automatic stay to exercise its setoff rights.

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In the Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1340

CITIZENS BANK OF MARYLAND, PETITIONER

v.

DAVID STRUMPF

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

INTEREST OF THE UNITED STATES

This case concerns whether, during the period that the creditor in a bankruptcy case is seeking relief from the automatic stay to exercise its setoff rights, the creditor may withhold payment of a debt owed to the debtor. This issue is of subtantial importance to the United States, whose agencies and instrumentalities are often creditors under federal programs involving loans, loan guarantees, contracts, assistance and benefit payments and tax collection activities. Indeed, two of the decisions upon which the court of appeals relied in the present case involved holdings that the United States violated the automatic stay by withholding a refund of overpaid taxes

for one year even though the debtor had a larger outstanding tax liability for a different year. Pet. App. 9, 10, citing *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985); *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983). A third decision relied on by the court of appeals involved efforts of the Small Business Administration to offset its loan claim against crop payments due the debtor from the Department of Agriculture. Pet. App. 7, citing *Small Business Administration* v. *Rinehart*, 887 F.2d 165 (8th Cir. 1989).

As petitioner notes (Pet. 8-23), the lower courts have reached a variety of conflicting results in addressing this recurring issue. As a result, federal agencies face disparate treatment of identical claims arising under national programs. The United States therefore has a substantial interest in the resolution of this recurring conflict.

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Bankruptcy Code are reprinted in the appendix to this brief.

STATEMENT

1. Petitioner is a bank conducting business in the State of Maryland. In 1989, petitioner loaned respondent approximately $5000. That loan was in default before respondent filed a petition for relief in bankruptcy under Chapter 13 in January 1991 (Pet. App. 3). Under Section 362 of the Bankruptcy Code, the filing of the petition in bankruptcy gave rise to an "automatic stay" of various types of activity by respondent's creditors. In particular, the filing stayed "the setoff of any debt owing to the debtor that arose before the commencement of the [bankruptcy] case." 11 U.S.C. 362(a)(7).

In October 1991, the bank moved for relief from the automatic stay in order to set off approximately $3200 then in respondent's checking account against the remaining balance that respondent owed on the loan. While the motion for relief from the stay was pending, the bank placed an "administrative hold" on the balance of approximately $3500 in respondent's checking account. The hold temporarily barred respondent from making withdrawals from the account. Respondent reacted to the bank's "administrative hold" by filing a motion in bankruptcy court seeking to have the bank held in contempt of the automatic stay (Pet. App. 4).

The bankruptcy court ruled on debtor's contempt motion before addressing the bank's prior motion for relief from the automatic stay. The court concluded that the bank's "administrative hold" on respondent's account represented a "setoff" in violation of the automatic stay and, as a sanction for violation of the stay, ordered the bank to pay actual and punitive damages and attorneys' fees to respondent (Pet. App. 34-36). At that time, the court reserved its ruling on the bank's motion for relief from the stay.

Nineteen days later, the bankruptcy court granted the bank's motion for relief from the stay and authorized the bank to set off respondent's remaining account balance against the unpaid loan. By that time, however, there was nothing left to set off because respondent had withdrawn all of his funds from the bank (Pet. App. 4-5).

2. The district court reversed the judgment holding the bank in violation of the automatic stay. The court concluded that the bank's temporary freeze of respondent's account during the period that the bank sought relief from the automatic stay was not a violation of the statute (Pet. App. 18-33).

3. The court of appeals reversed and reinstated the bankruptcy court judgment (Pet. App. 1-17). The court held that a creditor's administrative freeze of amounts subject to setoff is "tantamount" (*id.* at 9) to the exercise of the right of setoff and therefore violates 11 U.S.C. 362(a)(7). The court reasoned that its holding was compelled by "the clear and unambiguous language" of the statute, which prohibits any "setoff" during the automatic stay (Pet. App. 13-14). The court further stated that the bank's actions in freezing a debtor's accounts could substantially diminish the debtor's chances for successful rehabilitation (*id.* at 14-15). Concluding that the automatic stay had been violated by the bank, the court ordered reinstatement of the award of actual and punitive damages and attorneys' fees to respondent (*id.* at 15-16).

ARGUMENT

Section 362(a)(7) of the Bankruptcy Code provides an automatic stay of "the setoff" of any prepetition debt of the debtor by any creditor. 11 U.S.C. 362(a)(7). The court of appeals erred in this case in concluding that a "setoff" occurs whenever a creditor maintains the status quo by not turning over funds requested by the debtor. A "setoff" requires an affirmative act by the creditor; maintaining the status quo is not a "setoff." See pages 7-10, *infra*. Moreover, Sections 542(b) and 553 of the Bankruptcy Code expressly protect a creditor from the obligation to turn over funds owed to the debtor to the extent that the creditor claims a right of setoff. A creditor such as petitioner is not acting in contempt of the automatic stay by temporarily declining to pay to the debtor funds that the Bankruptcy Code expressly provides need not be paid. See pages 10-11, *infra*.

The decision in this case misapplies the interlocking set of Bankruptcy Code provisions that protect the setoff rights of bankruptcy creditors. In doing so, the court has enlarged the continuing disagreement that exists on the common, recurring question presented in this case. Review by this Court is needed to resolve this important conflict among the courts of appeals.

1. a. Several Sections of the Bankruptcy Code are implicated in this case. In order properly to understand the automatic stay of "the setoff" of prepetition debts under Section 362(a)(7) of the Bankruptcy Code, it is necessary also to consider other applicable provisions of that Code. In particular, Section 553 of the Code specifies that, with only two exceptions, the Bankruptcy Code "does not affect any right of a creditor to offset" prepetition debts. 11 U.S.C. 553(a). The two exceptions specified in Section 553 are the automatic stay of "the setoff" (under Section 362) and the limited right of the bankruptcy trustee to require payment of a debt secured by setoff by providing alternative, adequate protection for the setoff claim (under Section 363). 11 U.S.C. 553(a).[1] Subject only to those two exceptions, the

[1] Section 363 of the Bankruptcy Code permits a debtor in possession or trustee authorized to operate the debtor's business to "use, sell, or lease" property of the estate. Under that provision a debtor in possession or trustee may demand payment of a matured debt that is subject to a creditor's right of setoff in order to "use" the proceeds of the debt to operate the business. *Bank of America* v. *Edgins*, 36 B.R. 480, 483 (Bankr. 9th Cir. 1984). Since the proceeds (which secure the creditor's claim, 11 U.S.C. 506(a)) are considered "cash collateral" (11 U.S.C. 363(a)), the creditor may demand "adequate protection" of its interest as a condition of payment, 11 U.S.C. 363(e). See 2 Lawrence P. King et al., *Collier on Bankruptcy* § 363.02, at 363-16 (2d ed. 1994). See also *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 203-204 (1983). A debtor or trustee may force payment of a debt that is subject to

creditor's right of setoff is fully preserved in bankruptcy. *Stephenson* v. *Salisbury*, 967 F.2d 1069, 1076 (5th Cir. 1992); *B.F. Goodrich Employees Federal Credit Union* v. *Patterson*, 967 F.2d 505, 508 (11th Cir. 1992). In particular, Section 542(b) of the Bankruptcy Code specifies that a creditor who owes a debt to the debtor is *not* required to "pay" that debt to the extent that the creditor's claim represents a setoff against it. 11 U.S.C. 542(b).[2] A creditor such as petitioner cannot logically be said to have violated the automatic stay by temporarily declining to "pay" a debt that Section 542(b) specifies does not have to be paid at all.

The decision of the court of appeals in the present case failed to consider this carefully drafted scheme of interlocking provisions. By forcing the creditor to pay over the debt first and seek relief from the stay later, the decision wholly vitiates the right of setoff that Sections 553 and 542 purport to protect; a creditor obviously cannot set off a claim with a debt that it has already satisfied.

b. The automatic stay of any "setoff" under Section 362(a)(7) is not designed to defeat the ultimate right of setoff. Instead, it stays implementation of a setoff pending an "orderly examination of the debtor's and creditor's rights." *Stephenson* v. *Salisbury*, 967 F.2d at 1076. A creditor may initiate such an "orderly exam-

setoff, but only after notice and hearing at which the creditor whose claim is secured by the right of setoff may seek adequate protection. 11 U.S.C. 363(c)(2)(B). If the estate cannot provide adequate protection, the court cannot force payment to the estate. 11 U.S.C. 363(e).

[2] Section 506(a) of the Code provides further protection for the right of setoff by specifying that a creditor's claim against the debtor "is a secured claim" to the extent that it constitutes a setoff. 11 U.S.C. 506(a).

ination" by asking the court for relief from the stay.[3] 11 U.S.C. 362(d). A creditor who violates the stay by setting off the mutual debts without first obtaining the court's permission, however, may be liable for damages and attorneys' fees to any individual injured by the violation.[4] 11 U.S.C. 362(h). In concluding in this case that a creditor who seeks such an orderly determination of the right to exercise its setoff has violated the automatic stay, the court misapprehended what a "setoff" represents.

The crux of the court's ruling is that the temporary withholding of a payment on a debt constitutes a "setoff" to which the automatic stay applies. In reaching that conclusion, the court relied (Pet. App. 9-10) on its earlier decision in *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985), which in turn had relied on the reasoning of the Third Circuit in *United States* v. *Norton*, 717 F.2d 767 (1983). In *Norton*, which involved the setoff of a federal tax overpayment, the Third Circuit noted that the Bankruptcy Code neither defines the term "setoff" nor explains when a "setoff" occurs for purposes of the automatic stay. 717 F.2d at 772. The court chose to look to Pennsylvania law—rather than to federal internal revenue law—to determine when a "setoff" of federal tax liabilities occurs. *Ibid.* Applying Pennsylvania law, the court stated in *Norton* that "retention of a debtor's funds

[3] A trustee or debtor in possession also may initiate an examination of the creditor's setoff rights by seeking payment of the debt under Section 542(b) of the Bankruptcy Code, 11 U.S.C. 542(b).

[4] Under recent amendments to the Bankruptcy Code, the United States is now also liable for damages for a violation of the automatic stay. See 11 U.S.C. 106(a), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 113, 108 Stat. 4106.

by a creditor provides sufficient evidence of an intent to setoff." *Ibid.*, citing *Pittsburgh National Bank* v. *United States*, 657 F.2d 36 (3d Cir. 1981).[5] Invoking the analysis of *Norton* in *Reynolds*, the Fourth Circuit stated that it could not find any state or federal law as to when a "setoff" occurs with respect to tax overpayments. The court nonetheless elected to apply what it regarded as the "broader rationale" of *Norton* (764 F.2d at 1007):

[5] Pennsylvania applies a rule of "automatic setoff," under which a setoff is said to occur as a matter of law at the moment that the creditor's claim matures. See *Pittsburgh National Bank* v. *United States*, 657 F.2d at 38. Even if Pennsylvania law, rather than the Internal Revenue Code, were the appropriate nonbankruptcy law governing the setoff of federal tax overpayments (which we dispute, see note 6, *infra*), the Third Circuit's rationale in *Norton* would be incorrect. Under the "automatic setoff" doctrine of Pennsylvania, it is the maturation of a debt that, *by operation of law*, causes the debt "automatically" to be set off. See 657 F.2d at 38. If that reasoning were applied to a case involving taxes, a setoff could be said to occur "automatically" the instant that a tax overpayment was received. If the overpayment was received *before* bankruptcy, the setoff would be a *fait accompli* before the automatic stay ever arose and there would have been no stay violation. If, on the other hand, the overpayment was received *after* the bankruptcy petition was filed, the automatic stay would intervene to prevent the setoff from occuring "automatically" under state law. The state automatic setoff would be stayed by the federal automatic stay. No violation of the stay against setoffs could occur, at least not by operation of Pennsylvania's automatic setoff doctrine, upon which the Third purported to rely in *Norton*. Moreover, refusing to "pay" a debt for which a setoff exists is specifically authorized by Section 542(b) of the Bankruptcy Code, 11 U.S.C. 542(b), and thus cannot represent a violation of the stay against a "setoff" under Section 362(a)(7).

> If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished.

There are two significant defects in the reasoning applied by the Fourth Circuit in *Reynolds* and in the present case.

(i) If, as the court assumes, the term "setoff" in the Bankruptcy Code is to be defined by resort to non-Code state or federal law, the general rule is that a setoff requires (i) a decision to effectuate a setoff, (ii) an overt act accomplishing the setoff and (iii) a record of the setoff. See, *e.g.*, *Horton Dairy, Inc.* v. *United States*, 986 F.2d 286, 291 (8th Cir. 1993); *B.F. Goodrich Employees Federal Credit Union* v. *Patterson*, 967 F.2d at 513; *United States* v. *Bell Credit Union*, 860 F.2d 365, 369 (10th Cir. 1988); *Sisk* v. *Saugus Bank & Trust Co. (In re Saugus Gen'l Hosp., Inc.)*, 698 F.2d 42, 47 (1st Cir. 1983); *United States* v. *Citizens & Southern Nat'l Bank*, 538 F.2d 1101, 1107 (5th Cir. 1976), cert. denied, 430 U.S. 945 (1977); *Baker* v. *National City Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975). See Paul S. Groschadl, *"Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?*, 57 Am. Bankr. L.J. 75, 76 (1983).[6]

[6] With respect to federal taxes, the Internal Revenue Code provides a federal "setoff" rule (26 U.S.C. 6402(a)):

> In the case of any overpayment, the Secretary * * * may credit the amount of such overpayment * * * against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall * * * refund any balance to such person.

Under the Internal Revenue Code, like the rule generally applicable under state law, an affirmative act—an exercise of discretion to credit and refund the balance or to refund in full—

That general rule—rather than the exceptional Pennsylvania rule relied on in *Norton*—appears applicable in Maryland, where the dispute in the present case arose. See *Barrier* v. *Marine Midland Trust Co.*, 284 A.2d 418, 424 (Md. 1971). See also note 5, *supra*.

(ii) More fundamentally, the court's suggestion that prompt payment of a setoff is desirable to enhance "the debtor's chances for successful rehabilitation" (*United States* v. *Reynolds*, 764 F.2d at 1007) simply ignores Sections 542(b) and 363 of the Bankruptcy Code. Under Section 542(b), a creditor in bankruptcy is expressly *not* required to "pay" a debt owed to the debtor if that debt may be "offset" by a claim of the creditor. 11 U.S.C. 542(b). The trustee or debtor in possession may require a claim that is subject to setoff to be paid to the estate only by providing the creditor, after notice and hearing, with alternative, adequate protection for the setoff right. 11 U.S.C. 363(c)(2)(B). See note 1, *supra*.

A creditor who is not required to "pay" a claim subject to setoff under Section 542(b) cannot be said to have acted in contempt of the automatic stay by temporarily declining to "pay" that claim while seeking judicial authorization formally to set off the debt. Merely holding the account in suspense to preserve the setoff

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must occur before a setoff has been made. Other statutes governing governmental "setoffs" similarly contemplate the taking of affirmative action to accomplish the setoff. See 31 U.S.C. 3716 ("The head of an executive or legislative agency may collect by administrative offset."); 31 U.S.C. 3728 ("The Comptroller General shall withhold paying that part of a judgment against the United States Government presented to the Comptroller General that is equal to a debt the plaintiff owes the Government [and] * * * shall discharge the debt if the plaintiff agrees to setoff * * * or * * * have a civil action brought [to establish the Government's claim].").

rights that Sections 363 and 542 of the Bankruptcy Code expressly protect does not constitute a contempt of the stay.[7]

2. The courts of appeals have splintered in their efforts to resolve the common question that this case presents. The Third and Fourth circuits (in *Norton*, *Reynolds* and in the present case) and the Eighth Circuit (in *Small Business Administration* v. *Rine-*

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[7] Freezing the debtor's account while seeking relief from the stay would not violate aspects of the automatic stay other than Section 362(a)(7). Some courts have concluded that a freeze would violate Section 362(a)(3), which stays "any act * * * to exercise control over property of the estate." 11 U.S.C. 362(a)(3). Those courts reason that the bank holds the debtor's "funds" and that the freeze deprives the debtor of his right to order disbursal of the funds. See, *e.g.*, *Patterson*, 967 F.2d at 511. That view is wrong in both of its premises. The bank does not hold funds belonging to the depositor; it owes the depositor a debt. *Barnhill* v. *Johnson*, 112 S. Ct. 1386, 1389 (1992); cf. *United States* v. *Nordic Village, Inc.*, 112 S. Ct. 1011, 1017 (1992). When the depositor files for bankruptcy relief, his *claim* against the bank, not the money in his account, becomes property of the estate. See *Bank of Marin* v. *England*, 385 U.S. 99, 101 (1966). To the extent an account freeze is an exercise of control over funds in the account, it is not an exercise of control over property of the estate. Nor is it an exercise of control over any right of withdrawal, because the debtor has no such right. To the extent the account is subject to setoff, it constitutes cash collateral. The debtor must seek court permission to withdraw the funds. *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994).

Likewise, a freeze would not violate the stay under Section 362(a)(6) of "any act to collect [a prepetition debt]." 11 U.S.C. 362(a)(6). Because the Bankruptcy Code specifically protects setoff rights, preserving the status quo pending determination of the setoff cannot be construed as an act to collect. If it were, the provisions of Section 542(b) that specify that a debt "subject to setoff" need not be paid to the estate would be nullified. See 11 U.S.C. 542(b).

hart, supra) have held that a creditor violates the automatic stay by temporarily withholding payment of debts for which a setoff is available under state or federal law. By contrast, the Eleventh Circuit has held that a creditor does not violate the stay if, upon the debtor's demand, the creditor proceeds to the bankruptcy court, deposits the contested amount and seeks relief from the stay. *B.F. Goodrich Employees Federal Credit Union* v. *Patterson*, 967 F.2d at 511. The Fifth Circuit, moreover, has concluded that a creditor does not violate the stay by refusing a demand to pay a debt to the estate pending resolution of the creditor's right of setoff. *Stephenson* v. *Salisbury*, 967 F.2d at 1077; see also *Campbell* v. *United States*, 889 F.2d 658 (5th Cir. 1989) (court cannot sanction IRS under Section 502(d)—which authorizes disallowance of uncooperative creditor's claim—for refusing to pay debt to estate pending resolution of IRS's right to set off), cert. denied, 495 U.S. 933 (1990). Cf. *United States* v. *Inslaw, Inc.*, 932 F.2d 1467, 1472-1473 (D.C. Cir. 1991) (withholding property subject to disputed legal claims is not a violation of automatic stay; such a "view would turn every act of the possessor that implicitly asserts his title over disputed property into a violation of § 362(a) * * * creating a kind of universal end-run around the limits on turnover"), cert. denied, 502 U.S. 1048 (1992)).[8]

[8] The bankruptcy and district courts are also sharply divided in their disposition of this issue. Many courts have held that it does not violate the automatic stay for a creditor temporarily to "freeze" sums subject to offset and thereafter seek authority formally to set off the claim. See, *e.g.*, *In re Edgins*, 36 B.R. at 484; *Rio* v. *Army Aviation Ctr. Fed. Credit Union*, 82 B.R. 138, 143-144 (M.D. Ala. 1986); *Kenny's Franchise Corp.* v. *Central Fidelity Bank*, 22 B.R. 747, 748 (W.D. Va. 1982); *In re Gifford*, 174 B.R. 231, 232 (Bankr. W.D. Ky. 1994); *Moreira* v. *Digital Employees Fed. Credit Union*, 173 B.R. 965, 967 (Bankr. D. Mass. 1994); *In re Lough*, 163 B.R. at 588; *Weems* v. *United States (In re Custom Ctr., Inc.)*, 163 B.R. 309, 319 (Bankr. E.D. Tenn. 1994); *In re Briggs*, 143 B.R. 438, 445-450 (Bankr. E.D. Mich. 1992); *In re Learn*, 95 B.R. 495, 496 (Bankr. N.D. Ohio 1989); *National Bank* v. *Air Atlanta*, 74 B.R. 426, 427 (Bankr. N.D. Ga.), aff'd, 81 B.R. 724 (N.D. Ga. 1987); *Williams* v. *American Bank of the Mid-Cities*, 61 B.R. 567, 573-574 (Bankr. N.D. Tex. 1986); *Teamsters Credit Union* v. *Lee*, 40 B.R. 123, 126 (Bankr. E.D. Mich. 1984); *In re Gazelle, Inc.*, 17 B.R. 617, 620 (Bankr. W.D. Wis. 1982); *Third Nat'l Bank* v. *Carpenter*, 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981). Accord, 4 *Collier on Bankruptcy* ¶ 553.15[6], at 553-87 (15th ed. 1994). Other courts have held that a creditor's failure to pay a debt to the estate (including a bank "freeze" on the debtor's account) violates the automatic stay. See, *e.g.*, *Hudson* v. *United States*, 168 B.R. 449, 453 (Bankr. S.D. Ga. 1994); *In re Midway Indus. Contractor, Inc.*, 167 B.R. 139, 143-144 (Bankr. N.D. Ill. 1994); *In re Flynn*, 143 B.R. 798, 801 (Bankr. D.R.I. 1992); *Tavormina* v. *ITT Commercial Fin. Corp. (In re Aquasport)*, 115 B.R. 720, 722 (Bankr. S.D. Fla. 1990), aff'd, 155 B.R. 245 (S.D. Fla. 1992), aff'd, 985 F.2d 579 (11th Cir. 1993) (Table); *In re Woloschak Farms*, 74 B.R. 261, 264 (Bankr. N.D. Ohio 1987), vacated on other grounds, 109 B.R. 736 (N.D. Ohio 1989); *Executive Assoc.* v. *Southern Nat'l Bank*, 24 B.R. 171, 172 (Bankr. S.D. Tex. 1982).

This recurring conflict leads to uncertainty and wasteful litigation. The decisions to date have yielded a patchwork of inconsistent answers. This disparate treatment is especially confusing for creditors whose operations occur in more than one circuit. Moreover, in the circuits where a clear answer has not yet been provided, creditors can only speculate as to what steps—if any—they may take to protect setoff rights without violating the automatic stay.

This continuing uncertainty has particular significance for the federal government. Many federal departments, agencies and instrumentalities have national programs affected by this dispute. Agencies of the

United States that lend or collect funds, guarantee loans, enter into contracts, or distribute grants or benefits are all subject to the varying treatment that the circuits have afforded to a creditor's right of setoff. Review by this Court is warranted to resolve the continuing conflict on this common, recurring question.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX

1. 11 U.S.C. 362 (1988) provides in relevant part:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—

* * * * *

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor * * *.

* * * * *

(d) On request of a party in interest and after notice and hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or,

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

* * * * *

(h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

2. 11 U.S.C. 363 (1988) provides in relevant part:

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

* * * * *

(c)(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

* * * * *

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

* * * * *

3. 11 U.S.C. 506(a) provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

4. 11 U.S.C. 542(b) provides:

Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the

order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

5. 11 U.S.C. 553(a) provides in relevant part:

Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, * * *.

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CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights without violating the automatic stay provisions of the Bankruptcy Code, 11 U.S.C. § 362(a).

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BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONER

The American Bankers Association hereby respectfully submits this brief as amicus curiae in support of the Petitioner in accordance with the provisions of Rule 37.2 of the Supreme Court Rules. The parties have consented to this filing, and their written consents are filed with this brief.

INTEREST OF THE AMICUS CURIAE

The American Bankers Association is the principal trade association of the banking industry in the United States, representing banks located in each of the fifty states and the District of Columbia, including both national and state-chartered banks, and banks of all sizes, from small community banks, through regional and super-regional banks to money center banks. The Association's membership includes both independent and holding company owned banks, whose combined domestic assets total some ninety percent of all banking assets in the United States.

On behalf of its member banks, the American Bankers Association has a distinct interest in the question presented by this case in several respects. The question presented here is one that, through frequently recurring litigation, has divided the lower courts and has not been previously addressed by this Court. The interpretation of and interplay among the several provisions of the Bankruptcy Code at issue here are important to the day-to-day operations of banks, and, consequently, a definitive clarification of the law is devoutly to be desired. In addition, it is important that the decision of the Fourth Circuit be reviewed and reversed, for it endangers the very foundation of an increasingly important product offered by members of this Association and other lenders, more of which below.

REASONS FOR GRANTING THE WRIT

This is a "banker's dilemma" case in which the Respondent was both a depositor in and a borrower from the

Petitioner bank. The Respondent specifically and clearly agreed, by written contract, that the bank would have the right to set off amounts owed to the bank against funds that the Respondent had on deposit in the bank in the event of default. The Respondent did, in fact, default on the loan and filed for bankruptcy. Under the Bankruptcy Code, the Debtor is entitled to an "automatic stay" of proceedings to collect debts against the Debtor. (11 U.S.C. § 362(a)).

When the Respondent filed for bankruptcy, the bank did not immediately exercise its right of setoff against the Respondent's deposit account, but rather imposed an administrative hold on a portion of the deposit account sufficient to protect its contractual rights, so as to preserve its ability to set off if and when the automatic stay were lifted. Under the administrative hold, the bank would refuse to honor checks drawn against the Respondent's account that would reduce the balance below the amount the Respondent owed.

The Fourth Circuit held, in the case below, that the bank's actions violated the automatic stay provisions of the Bankruptcy Code. But failure or inability by a bank to impose an administrative hold on a deposit account under these circumstances is tantamount to forfeiture of the bank's rights--a drastic outcome imposed upon no other type of creditor. The bank was compelled to lift its administrative hold on the Respondent's funds under penalty of contempt of court. That permitted the Respondent to withdraw all funds from the bank, which, of course, he did, thereby depriving the bank of the security for which it bargained. It did the bank no good for the lower courts to hold--as they did, well

after the fact--that the bank was entitled to relief from the automatic stay. By that point, the banks' contractual rights had long since been spirited away in fact, and it had no effective remedy for that abuse. (*See, e.g.*, L. King, 2 *Collier on Bankruptcy*, ¶ 363.04 at 363-23; *Standards and Sanctions for Use of Cash Collateral under the Bankruptcy Code*, 63 Tex L.Rev. 341 (1984); *In re Williams*, 61 B.R. 567, 576 (N.D. Tex. 1986).

Section 362(a)(7) of the Bankruptcy Code provides, in relevant part, that "a petition filed under section 301, 302 or 303 of this title...operates as a stay, applicable to all entities, of--...the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." It obviously does no violence to the plain language of the statute to permit a bank to impose an administrative hold on its depositor's funds. Doing so does not convert the depositor's funds to the bank's own, nor does it permit the bank to exercise dominion and control over those funds. It merely prevents the **depositor** from doing so, thereby preserving the status quo pending determination by the Bankruptcy Court of the respective rights of the parties. It is the only feasible way for the bank to implement the provisions of Section 542(b) of the Bankruptcy Code: "[A]n entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, **except to the extent that such debt may be offset under section 553 of this title against a claim against a debtor.**" The Fourth Circuit decision below effectively strips this section of the Bankruptcy Code

of any meaning and effect, at least in the context of the fairly common fact pattern presented here.

As the Petition for Writ of Certiorari correctly points out, other courts have reached conclusions at odds with the Fourth Circuit's in comparable cases. *See, e.g., In re Patterson*, 967 F.2d 505 (11th Cir. 1992); *In re Davis*, 889 F.2d 658 (5th Cir. 1989), *cert. denied sub nom. Campbell v. United States*, 495 U.S. 933 (1990); *In re Edgins*, 36 B.R. 480 (Bankr. 9th Cir. 1984)[1] Inconsistent results in the lower courts on fundamental issues of bankruptcy law is quite a sufficient independent reason for the Court to grant the Petition for Writ of Certiorari under Rule 10 of the Supreme Court Rules, and no point would be made by our repetition of the arguments to that effect already before the Court in the Petition for Writ of Certiorari.

In addition to that, however, the precedent set by the Fourth Circuit decision, if it stands unreviewed and unreversed, will endanger an important banking product that is not even directly involved in this case. This case involves a fairly conventional loan product and fairly conventional checking account. As unjust as the result is to the bank in this case and to any bank similarly situated in the future, the consumer lending business and the checking account business will go on. The same may not necessarily be said for the secured credit card business.

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[1] *Contra*: *Small Business Administration v. Reinhardt*, 887 F.2d 165 (8th Cir. 1989); *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985); *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983).

A "secured credit card" looks and acts, in the marketplace, exactly like an ordinary Visa card or Mastercard. It allows customers to "charge" purchases of goods and services; the customer is billed on a monthly basis and is allowed to carry a balance from one month to the next after making a required minimum payment. The primary difference between a secured credit card account and a conventional credit card account is that the secured card holder is obligated to maintain a deposit balance in the issuing financial institution. The required balance is tied to the line of credit available to the customer. Most issuers require a deposit equal to 100 percent of the line of credit, some a bit more, some a bit less. Typically, a secured credit card account costs the customer somewhat more than is charged in the case of a conventional credit card, in terms of annual fees, application fees or interest rates or some combination thereof.[2] That being the case, the only customers who would choose to open a secured credit card account are those who--almost by definition--are not creditworthy enough to qualify for a conventional credit card account. Stated from the opposite perspective, a safely and soundly run bank would not and could not extend credit to secured credit card customers if it could not count on the security of the required deposit account for each of those customers.

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[2] *See* RAM Research Corporation, "Secured Card Survey," *CardTrak*, Issue 48, December, 1994 at 7, for selected terms and conditions offered by various issuing institutions.

The benefit to customers of a secured credit card account, in addition to the convenience of charging purchases, is that it enables them to establish creditworthiness so that, after a time, they will be eligible for a conventional credit card. The primary beneficiaries of secured credit card programs are young people, just starting out, recent immigrants with insufficient time to have established a credit history in this country, widowed or divorced persons who had never established credit histories independent of their spouses, and people with impaired credit histories[3]--the very people to whom the Bankruptcy Code is designed to grant a "fresh start." *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904).

The secured credit card market is not insignificant. There are already 1.5 to 2 million cards outstanding and the market has only begun to be tapped. There are an estimated 13 to 14 million people who do not have a credit history and another four to six million who have impaired credit records.[4] Approximately 300 financial institutions now offer secured credit cards.[5]

---

[3] Phillips Business Information, "Secured Cards Gain Popularity as a Way to Reach Niche Segments," *Credit Risk Management Report*, August 15, 1994 at 1.

[4] Fickensher, *Big Banks Looking to Secured Cards for Growth*, American Banker, March 1, 1995 at 14.

[5] Lucas, "The Shakeout in Secured Cards," *Credit Card Management*, October 1994 at 54.

The balance required of a customer under a secured credit card program is a deposit account, just as was the deposit account involved in this case. It is every bit as much the "cash collateral" within the meaning of Section 363(a) of the Bankruptcy Code as the deposit account involved in this case. If, as the Fourth Circuit held below, there is no effective way for the bank to have prevented a withdrawal of funds by the Respondent in this case--despite contractual and statutory protections of the bank's rights--it is hard to imagine how a secured credit card lender could prevent its borrower from withdrawing the required funds on deposit after defaulting on his or her credit card loans and filing for bankruptcy. If that is to be the case, the entire logical underpinnings of the secured credit card program disappears. No longer will lenders be able to extend credit to otherwise noncreditworthy persons. That outcome is counter to sensible public policy, and benefits no one--not the lender, not the customer.

CONCLUSION

For all of the reasons set forth in the bank's Petition for Writ of Certiorari and because of the importance of the issue, as outlined above, to an entire marketplace not otherwise represented in this litigation, the American Bankers Association, as amicus curiae, respectfully urges the Court to grant the Petition.

Respectfully submitted,

/s/

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Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fourth Circuit

BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights, without violating the bankruptcy stay under 11 U.S.C. § 362(a).

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BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

I. INTEREST OF THE AMICI CURIAE

NationsBank, N.A. (Carolinas), NationsBank, N.A., and The First National Bank of Maryland[1] (collectively

[1] Pursuant to Supreme Court Rule 29.1, the Banks disclose the following: The parent company of NationsBank, N.A. and NationsBank, N.A. (Carolinas) is NB Holdings Corporation. NationsBank, N.A.'s only direct subsidiary (other than wholly owned subsidiaries) is Suburban Artery Limited Partnership. NationsBank, N.A. (Carolinas) has no direct subsidiaries that are not wholly owned. The parent company of The First National Bank of Maryland is First

the "Banks") hereby respectfully file their brief *amici curiae* in this case. The consent of the attorneys for the petitioner and the respondent has been obtained.

The United States Court of Appeals for the Fourth Circuit (the "Fourth Circuit") in *Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155, 157 (4th Cir. 1994) (the "Decision"), held that a bank violates the automatic stay of 11 U.S.C. § 362(a) by placing an administrative hold on a debtor's deposit account while seeking relief from the automatic stay to exercise the right of setoff. The interest of the Banks in this case arises from the burden that this decision places upon their operations. Each of the amici are regional banks. NationsBank, N.A. and NationsBank, N.A. (Carolinas) currently operate in more than one state. NationsBank, N.A. operates in more than one federal judicial circuit. Because each of the Banks has an interest in regional banking, they are in a unique position to delineate the effect the Fourth Circuit's decision will have on the banking industry.

NationsBank, N.A. and NationsBank, N.A. (Carolinas) are national banking associations with banking operations in Maryland and the District of Columbia for NationsBank, N.A. and North Carolina and South Carolina for NationsBank N.A. (Carolinas). Both banks are direct subsidiaries of NB Holdings Corporation, which owns other banking associations in Florida, Georgia, Kentucky, Tennessee, Texas, and Virginia. The First National Bank of Maryland is also a national banking association

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Maryland Bancorp. The First National Bank of Maryland has no direct subsidiaries that are not wholly owned.

with operations in Maryland. Each of the Banks has numerous customers that live in one state and maintain bank accounts in another state. The issue of whether a creditor may refuse to pay debts to a debtor to protect its right to setoff pending relief from the automatic stay is a fundamental aspect of post-petition debtor-creditor relations and is raised in countless bankruptcy cases.

The current conflict among the circuits and among the various district and bankruptcy courts has serious consequences for the Banks. For example, NationsBank, N.A. operates branches in both the Fourth Circuit and the District of Columbia Circuit. The conflict leaves NationsBank, N.A. with no guidance as to what action to take when a customer who resides in the District of Columbia but banks in Maryland files for bankruptcy relief in the District of Columbia.

Although administrative holds are not prohibited by the bankruptcy court for the District of Columbia, NationsBank, N.A. risks a violation of the stay and resulting sanctions if it freezes demand deposit accounts in both jurisdictions. Of course, the debtor/borrower can effectively circumvent a hold communicated only to branches located in the District of Columbia by withdrawing funds from branches located in Maryland. Moreover, as the prohibitions on interstate banking relax, and banks begin to engage in banking across multiple state lines, banks will be required to maintain separate systems for tracking and monitoring demand deposit accounts in each jurisdiction if the Decision is allowed to stand. The Banks are in a unique position to address the serious negative consequences of the *Strumpf* holding for those who currently engage in interstate banking and those

who intend to pursue the benefits of recent legislation permitting banks to operate branches in more than one state.

II. SUMMARY OF ARGUMENT

The Decision conflicts with decisions from the Eleventh and Fifth Circuits. Moreover, conflicting decisions regarding the appropriateness of an administrative hold in a bankruptcy setting are proliferating rapidly in the lower courts of virtually all circuits, and the need for guidance from this Court is acute. This conflict directly burdens banks that currently engage in interstate banking. The Decision also conflicts with the purposes of the Interstate Banking Act and will impede the purpose and intent of that legislation.

The Decision is contrary to both the language and the policies underlying the United States Bankruptcy Code (the "Bankruptcy Code"). The opinion, which addresses those policies in a cursory fashion, fails to address the tension created by the various sections of the Bankruptcy Code that create and govern the debtor's and creditor's rights in cash collateral. The opinion ignores certain sections of the Bankruptcy Code that directly create a specific balance of rights.

III. ARGUMENT

A. Special and important reasons support the issuance of the writ in this case.

The Decision furthers a division among the courts. The conflict among jurisdictions will seriously interfere

with the efficient development of interstate banking. Further, the decision improperly discriminates against bank creditors by creating an artificial distinction between lending institutions and other creditors who possess setoff rights.

1. The decision furthers a conflict among jurisdictions that impedes the ability of banks to engage in interstate banking.

a. Jurisdictions are currently divided as to permissibility of the administrative freeze pending relief from the automatic stay.

Although the Fourth Circuit viewed its decision as one of first impression among circuit courts, it recognized that several circuit courts have addressed very similar questions. *Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155, 157 (4th Cir. 1994). In fact, the circuit courts are divided as to the issue presented to this Court in the petition for writ of *certiorari* (the "Petition"). *Cf. Small Business Administration v. Rinehart*, 887 F.2d 165 (8th Cir. 1989), *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), *United States v. Norton*, 717 F.2d 767 (3rd. Cir. 1983) *with In re Patterson*, 967 F.2d 505 (11th Cir. 1992) *and In re Davis*, 889 F.2d 658 (5th Cir. 1989), *cert. denied*, 495 U.S. 933 (1990).

The Fourth Circuit held that "an administrative hold is tantamount to the exercise of the right of setoff and thus violates the automatic stay." *Strumpf*, 37 F.3d at 158. The crux of the opinion in *Strumpf* is that the Bankruptcy Code not only permits, but requires, that the debtor have

use of deposited[2] funds, which are potentially subject to setoff, pending a judicial determination of the right of setoff. *Strumpf*, 37 F.3d at 158-159. In *Norton* and *Reynolds*, the Courts of Appeals for the Third and Fourth Circuits each held that the IRS violated the automatic stay by freezing[3] funds owed to a debtor in order to preserve its right to setoff. *Norton*, 717 F.2d at 771-771; *Reynolds*, 764 F.2d at 1007. In *Rinehart*, the Court of Appeals for the Eighth Circuit similarly determined that the creditor exercised control over funds of the debtor in violation of section 362(a)(3) by refusing to turnover funds owing to the debtor. *Rinehart*, 887 F.2d at 169.

The analysis employed by the courts in each of these cases is nearly identical. Each court focused almost exclusively on the relationship between sections 362 and 553 of

[2] Depositors commonly misperceive the nature of a bank deposit. It is well established that a general bank deposit creates a debtor-creditor relationship between the bank and the depositor. The bank simply owes a debt to the depositor which is payable on demand. *New York County Nat'l Bank v. Massey*, 192 U.S. 138 (1904); *Keller v. Fredicktown Sav. Inst.*, 66 A.2d 924, 925 (Md. 1949).

[3] A freeze, an administrative freeze, or a hold is nothing more than a bank's way of communicating that it declines to pay its debts to a depositor. Unlike smaller businesses, financial institutions face significant communicative and technological difficulties in manifesting an intent not to pay. When a bank determines that it does not wish to pay all or a portion of a debt that it owes to a depositor, then the bank must notify every teller at every branch in every state where it has operations as well as all Automatic Teller Machines ("ATMS"). The only way that a bank can accomplish this is by electronically coding its computers. This electronic coding is commonly referred to as an "administrative freeze" or an "administrative hold."

the Bankruptcy Code and failed to consider section 542(b) in determining the respective rights of debtor and creditor. *See Strumpf*, 37 F.3d at 157, n.* (mentioning section 542 in footnote only); *Rinehart*, 887 F.2d at 168-169; *Reynolds*, 764 F.2d at 1006 (creditor's contention "involves two sections of the Bankruptcy Code:" sections 362 and 553); *Norton*, 717 F.2d at 771 ("The interaction of sections 553 and 362 and the precise meaning of the term setoff form the core issue of this case."). The Fourth Circuit relied heavily on *Reynolds* in its analysis, and also noted that *Norton* and *Rinehart* "are on slightly different facts but are fully in accord with our decision." 37 F.3d at 158.

In contrast, the Fifth Circuit has held that a creditor should not be penalized for refusing to turn funds over to the debtor pending the final disposition of claims between the creditor and debtor. *Davis*, 889 F.2d at 662-663. In *Davis*, the court noted that creditors should not be punished for delaying payment until the amount of claims is finally determined because "otherwise the right to setoff is worth little more than the book in which it is found." *Id.* at 662. Although the court in *Davis* did not specifically rely on section 542, the decision recognizes a creditor's right to refuse to pay a debt to the debtor if necessary to protect setoff rights. *Id.* at 661-662.

Alternatively, the Eleventh Circuit Court of Appeals, while finding that an administrative hold is not permissible, encouraged banks to pay funds subject to setoff into the registry of the court and seek *ex parte* relief from the bankruptcy court. *Patterson*, 967 F.2d at 511. The court in *Patterson* noted that this approach would protect banks from the risk that funds subject to a valid right of setoff would be dissipated before the entitlement to set off the

funds could be established. *Id.* This holding is directly contrary to the conclusion of the Fourth Circuit that a hold on an account is impermissible because it "deprive[s] the debtor of the use of the funds pending the outcome of the motion for relief from stay." *Strumpf*, 37 F.3d at 158. Further demonstrating the differences in the views of the Eleventh Circuit and Fourth Circuit, the Fourth Circuit also stated that section 362 allows a debtor to defeat a creditor's right of setoff. 37 F.3d at 159.

The Bankruptcy Appellate Panel of the Ninth Circuit has held that a bank may place an administrative hold on funds subject to setoff prior to receiving relief from stay. *In re Edgins*, 36 B.R. 480 (9th Cir. BAP 1984).[4] In contrast to the opinions in *Strumpf*, *Reynolds* and *Norton*, the panel in *Edgins* recognized that "[t]his case, despite its simple facts, involves interaction of the automatic stay of 11 U.S.C. section 362, setoffs under 11 U.S.C. section 553, turnover of property under 11 U.S.C. section 542(b), determination of secured status under 11 U.S.C. section 506(a), and use of cash collateral under 11 U.S.C. section 363." 36 B.R. at 482.

Finally, as noted in the petitioner's brief, widespread confusion exists at both the district court and bankruptcy court level on this issue. Bankruptcy courts without guidance from their own circuit or district court cite conflicting authority and devise their own solutions. *See e.g. In re*

[4] Decisions by the Bankruptcy Appellate Panel constitute binding precedent on all bankruptcy courts within the Ninth Circuit. *In re Windmill Farms, Inc.*, 70 B.R. 618 (9th Cir. BAP 1987) *rev'd on other grounds* 841 F.2d 1467 (9th Cir. 1988); *In re Ehrman*, 171 B.R. 683 (Bankr. D. Ariz. 1994).

Williams, 61 B.R. 567, 572 (Bankr. N.D. Texas 1986) (noting that issue has "sparked intense debate in the courts and among commentators" and finding hold permissible) and *In re First Conn. Small Business Inv. Co.*, 118 B.R. 179, 181 (Bankr. Conn. 1990) (noting that issue "has been the subject of conflicting decisions and commentary" and finding that hold violates stay). This conflict currently creates uncertainty for banks operating in districts lacking authority on the issue and increases the legal and administrative costs incurred when a customer files for bankruptcy.

b. The widespread conflict among jurisdictions increases the costs of developing and managing interstate branch banking.

The lack of uniform treatment creates practical problems for banks operating in more than one state. If freezes are permitted in some jurisdictions but not in others, then banks must devise methods for allowing some branches to implement an administrative freeze but not others. Already this conflict poses difficulties for regional lenders such as the Banks.[5] As interstate branch banking develops, the lack of uniformity and certainty

[5] Pursuant to 12 U.S.C. §§ 30 and 36, NationsBank, N.A. already operates multistate branches in both the District of Columbia and Maryland, and NationsBank, N.A. (Carolinas) operates branches in North and South Carolina. These two sections permit the creation of unified multistate banks so long as their headquarters are within thirty miles of each state's boundary. NB Holdings Corporation created NationsBank, N.A. as its first unified multistate bank in 1994.

will become an even more costly problem. As such, the conflict between jurisdictions runs directly contrary to an important goal of Congress in passing landmark interstate banking and branching laws in 1994.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Banking Act") was passed by Congress in 1994 and will become effective in September, 1995.[6] The Interstate Banking Act reversed the established policy of restricting a bank's ability to operate branches in more than one state. H.R. Rep. No. 448, 103 Cong., 2d Sess. 19 (1994) *reprinted in* 1994 U.S. Code Cong. & Ad. News 2039, 2042 (hereinafter H.R.Rep. No. 448).

A primary goal of the Congress in passing the Interstate Banking Act was to promote greater flexibility and efficiency in the national banking system. As stated in the legislative history, "enacting this bill will yield important benefits to the banking system and to the nation's economy. First, it will give banks an opportunity to structure themselves more efficiently, eliminate duplicative functions, and reduce expenses . . . ." H.R. Rep. No. 448 at 19, 1994 U.S. Code Cong. & Ad. News at 2042, *quoting* Letter of Under Secretary of the Treasury Frank N. Newman. Remarks by Representative Neal and Representative McCollum further evidence congressional intent to

[6] The Interstate Banking Act will generally permit bank holding companies to acquire banks in any state beginning on September 29, 1995. Beginning in 1997, banks will be permitted to engage in interstate branch banking through merger or by establishing new branches in foreign states.

improve banking efficiency and expand the geographic scope of banking operations,

> Liberalized interstate banking and branching laws will also give banks greater organizational and operational freedom. Currently, the banking industry is the only industry in the nation in which corporations are permitted to operate across state's lines only if they establish a separate company in each state. Many bankers view this requirement as wasteful, because its mandates multiple boards of directors and regulatory reports, and forces transactions between different banks within the same holding company to be carried out in an arm-lengths manner . . . .

H.R. Rep. No. 448 at 19, 1994 U.S. Code Cong. & Ad. News at 2062. The Congressmen's remarks also emphasize the importance of allowing banks to engage in business across the country and thus expand the geographic scope of banking activities. H.R. Rep. No. 448 at 19, 1994 U.S. Code Cong. & Ad. News at 2064.

Absent a resolution of the conflict between jurisdictions on this issue, banks operating branches in more than one state will face different rules governing the permissibility of protecting their rights through an administrative freeze prior to receiving relief from the automatic stay. Banks will be compelled to identify customers who reside in districts permitting administrative freezes and treat those customers differently than those who file for bankruptcy in districts where the freeze is

not permitted.[7] The cost of devising a solution to this problem and the continuing administrative costs of managing duplicate systems are exactly the kinds of costs Congress sought to reduce or eliminate in introducing interstate banking.

2. The decision improperly discriminates against bank creditors by creating an artificial distinction between banks and all other creditors that may owe money to debtors.

The Court should grant the Petition because the Decision treats banks differently from all other creditors in the absence of a statutory basis for doing so. In failing to recognize that an administrative hold or an administrative freeze is nothing more than a mere declination of payment of a debt, the Decision denies statutory rights to banks that are afforded to other creditors. Specifically, the Decision treats a bank's election to exercise its rights under section 542(b) as a violation of the automatic stay, while other creditors routinely exercise these rights without penalty.

Under section 542(b), Congress expressly protected the setoff rights of creditors by providing that although all creditors are required to pay a debtor immediately upon demand all sums that they owe, creditors are also

[7] This task is made more complicated by the number of potential individual debtors who live in one federal district but work in another. The legislative history to the Interstate Banking Act points out that four million Americans commute daily to and from work across state lines. H.R. Rep. No. 448 at 57, U.S. Code Cong. & Ad. News at 2057.

entitled to refrain from paying any sums owed to the extent they have setoff rights. Individual and small business creditors exercise their rights under section 542(b) by simply not paying. As a practical matter there is nothing more they need to do to manifest and effectuate their intent not to pay on demand; they simply decline to make a payment.

As discussed above, however, banks encounter significantly greater difficulties in manifesting an intent not to pay because a bank must communicate its election to decline payment to numerous tellers and ATMS. Absent the ability to communicate such an instruction to its branches and ATMS, banks are unable to protect their rights under sections 542(b) and 553. Once a debtor has withdrawn funds from a deposit account or permitted others to withdraw such funds (by continuing to write checks on such account) then the bank's right of setoff is extinguished. U.C.C. § 9-306(2) (1978). *See e.g. In re Archer*, 34 B.R. 28 (Bankr. N.D. Tex. 1983) (turnover of funds extinguished setoff rights although monies constitute cash collateral).

A fundamental policy recognized by the Bankruptcy Code is parity of treatment among similarly situated creditors. Section 542 draws no distinction between lending institutions and other creditors. To the contrary, the legislative history of section 542 explicitly anticipates that it will apply to banks. H.R. Rep. No. 595, 95th Cong., 1st Sess. 369 (1977); S. Rep. No. 989, 95th Cong., 2d. Sess. 84 (1978). The Decision, therefore, violates the express congressional intent behind section 542.

Two other sections of the Bankruptcy Code provide supplemental protection to bank creditors with a right of setoff. The Bankruptcy Code treats creditors with a right of setoff as secured to the extent of the amount of their claim subject to setoff. 11 U.S.C. § 506(a). The Bankruptcy Code also treats deposit accounts as cash collateral pursuant to section 363(a). Debtors are specifically prohibited from using cash collateral absent consent from the secured creditor or court authorization after notice and a hearing. Thus, to the extent that a bank holds a pre-petition claim against the debtor, section 363 prohibits the debtor from using the deposits on account. Given the status of a bank with setoff rights as a secured creditor under section 506(a) and the additional protection given to cash collateral by section 363, there is no basis for concluding that Congress meant to treat banks less favorably than other creditors with setoff rights.

In cases addressing demands for turnover under section 542 made on creditors other than banks, courts routinely recognize the right of a creditor with setoff rights to refuse a demand for payment by the debtor pursuant to sections 542(b) and 553. *See e.g. In re G.S. Omni Corp.*, 835 F.2d 1317, 1318 (10th Cir. 1987) (existence of valid setoff rights a proper defense to turnover action); *In re Suncrete Corporation*, 21 C.B.C.2d 185, 188 (Bankr. M.D. Fla. 1989) (creditor not required to file proof of claim in order to assert affirmative defense of setoff in turnover action); *Posey v. Internal Revenue Service*, 156 B.R. 910, 916 (W.D.N.Y. 1993) (sections 542(b) and 553 permit creditor with valid setoff rights to refuse to pay pre-petition debt to debtor even where proceeds of debt would constitute exempt property of debtor). There is no suggestion in

these cases that the creditors effectuated setoff or otherwise violated the automatic stay by refusing to pay a debt to the debtor. *See also In re Fulghum Construction Corp.*, 23 B.R. 147 (Bankr. M.D. Tenn. 1982) (Although creditor should have filed a motion for relief from stay to present issue to court early in case, it was nonetheless proper to assert a right of setoff in answer to turnover complaint. Trustee not entitled to recover amount owed to debtor under pre-petition contract where amount owed by debtor to creditor exceeds amount outstanding on contract).

The administrative hold is the only mechanism available to a bank to evidence and effectuate its declination to pay. A bank's rights are no different than those afforded to a sole proprietor, or a small business, except that the refusal to pay is communicated to employees and machines electronically due to the technological and geographic demands of a large financial institution. The decision in *Strumpf* inappropriately treats banks differently from other creditors by removing the only way they may protect their statutory rights. Such disparate treatment is not contemplated by the statutory language articulated by Congress, nor is there any secondary evidence of a Congressional intent to impose such disparate treatment. Accordingly, the Banks request that this Court grant the Petition in order to ensure that all creditors possessing setoff rights receive the same treatment under the Bankruptcy Code.

B. The question presented by the petition is an important question of federal law.

The Banks also request that the Court grant the Petition because the Fourth Circuit erred in ruling that Citizens violated the automatic stay. The Decision is in error because it failed to recognize Citizens' rights under section 542, the nature of the frozen funds as cash collateral and the prohibition imposed by the Bankruptcy Code on the use of such cash collateral.

Section 542(b) requires creditors that owe a debt to the debtor to pay such debt, except to the extent that the debt may be offset under section 553 against a claim against the debtor. 11 U.S.C. § 542(b).[8]

Thus, section 542(b) permits creditors with a right of setoff under state law to refuse a demand by the debtor that the debt be paid. *See Davis*, 889 F.2d at 661. Although a creditor must receive relief from stay as a precondition to setting off amounts owed to the debtor from amounts owed by the debtor, the creditor is permitted to protect his right to do so pending a hearing on the matter. *Id; Edgins*, 36 B.R. at 483.

If a creditor has a valid setoff right, the Bankruptcy Code provides that the creditor's claim is secured to the "extent of the amount subject to setoff." 11 U.S.C. § 506(a). Financial institutions, whose collateral includes

[8] Section 553 preserves a creditor's otherwise existing right of setoff, but prevents a creditor from actually exercising that right until the creditor has obtained relief from the automatic stay. 11 U.S.C. § 553(a).

"cash collateral," such as demand deposits, receive special protection because of the unique nature of their collateral. 11 U.S.C. § 363. Specifically, debtors are prohibited from using cash collateral absent consent from the creditor or court authorization after notice and hearing. 11 U.S.C. § 363(c). Creditors secured by reason of a right of setoff against a deposit account are included within the protection of section 363. 2 James W. Moore & Lawrence P. King, *Collier on Bankruptcy* ¶ 363.02 (15th ed. 1994).

As noted by the Bankruptcy Appellate Panel in *Edgins*, this statutory framework establishes a "stalemate" or balance with regard to the funds subject to setoff. *Edgins*, 36 B.R. at 483. Neither the creditor nor the debtor can place those funds permanently out of the reach of the other without court authority. *Id. See also, Patterson*, 967 F.2d at 511. This situation can be altered by the court upon request of either the debtor (by filing a motion for permission to use the cash collateral pursuant to section 363 or for turnover pursuant to section 542) or the creditor (by filing a motion for relief from stay). *Id.*

The Fourth Circuit analyzed the stay issue without reference to the important rights extended to creditors by sections 542(b), 506(a) and 363. Although the Decision notes sections 542 and 506, it makes no effort to apply those provisions to the facts of the case. *Strumpf*, 37 F.3d at 157, n.*. Rather, the Court reviewed only section 362(a)(7) and section 553. In so doing, the Court ignored the statutory balance created by the Bankruptcy Code.

The Fourth Circuit did not recognize the nature of the deposit account as cash collateral. In reaching its

decision, the court stated that a freeze was tantamount to an actual setoff because it deprived the debtor of its use of the funds. 37 F.3d at 158. The court also stated that pursuant to 362(a)(7), the debtor was permitted to use the funds, even if this ultimately defeated the creditor's right of setoff. 37 F.3d at 159. That incorrect premise is directly contrary to the provisions of section 506(a) and 363. *Edgins*, 36 B.R. at 483; *See also, Patterson*, 967 F.2d at 511.

Under the Decision, banks are now subject to the risk that they may not obtain the intervention of the courts until after the funds are dissipated. Even judicial intervention may have little meaning, however, because when cash is turned over to the debtor and no longer identified, it may lose its character as cash *collateral*. *See Davis*, 889 F.2d at 662; *Patterson*, 967 F.2d at 511. Once the cash is commingled with other cash or spent by the debtor, it is no longer identifiable and may not be subject to the bank's security interest. U.C.C. § 9-306(2). This result is contrary to the statutory language and policy of the Bankruptcy Code. *Edgins*, 36 B.R. at 483-84. Further, the rule set forth in the decision invites abuse for which there is no effective remedy.[9]

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[9] Although prohibited from using cash collateral under the Bankruptcy Code, not all debtors carry out that statutory duty. *Williams*, 61 B.R. at 576; Groschadl, *"Freezing the Debtor's Bank Account: A Violation of the Automatic Stay?,"* 57 Am. Bankr. L.J. 75, 77 (1983). The Courts have consistently recognized that there is no true remedy for a debtor's wrongful use of cash collateral, because the cash is gone. This unique risk is explicitly recognized by Section 363. Stephen C. Mount, Note, *Standards and Sanctions for Use of Cash Collateral Under the Bankruptcy Code*, 63 Tex L.Rev. 341 (1984); 2 *Collier on Bankruptcy*, ¶ 363.04 at 363-23.

The facts of this case illustrate well the need to acknowledge the full scope of the statutory framework established by the Bankruptcy Code. Citizens placed a hold on a borrower/debtor's account to the extent of the approximate amount of its claim against the borrower/debtor. After placing the hold, Citizens promptly filed a motion for relief from stay seeking permission to setoff those funds. The bankruptcy court ultimately determined that Citizens had a valid right to setoff Mr. Strumpf's checking account against its pre-petition unsecured claim. However, because the court had previously required Citizens to "unfreeze" the funds on hold, by the time the stay was lifted Citizens could no longer identify the cash that had been its collateral. As a result, Citizens was left with an unsecured claim. If the Decision is allowed to stand, banks will be left without opportunity to enforce rights granted to creditors by the Bankruptcy Code.

IV. CONCLUSION

For these reasons, NationsBank, N.A. (Carolinas), NationsBank, N.A., and The First National Bank of Maryland respectfully request that this Court grant the Petition for Writ of *Certiorari*.

Respectfully submitted this 7th day of March, 1995.

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In The

Supreme Court of the United States

October Term, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fourth Circuit

BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH DISTRICT

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QUESTION PRESENTED FOR REVIEW

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights, without violating the bankruptcy stay under 11 U.S.C. § 362(a).

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BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH DISTRICT

I. INTEREST OF THE *AMICUS CURIAE*

Credit Union National Association, Inc. ("CUNA")[1] seeks permission to appear and argue as to the matters

[1] CUNA is the national trade association for credit unions and represents the interests of approximately 90 percent of the more than 12,590 federal and state-chartered credit unions operating in the United States that have approximately 67,000,000 consumer members. CUNA is organized for the purpose of representing and advocating the interests and rights of credit unions.

raised in this bankruptcy appeal as *amicus curiae*. Petitioner and Respondent have consented to CUNA's appearance as *amicus*.

In Citizens Bank of Maryland v. Strumpf, 37 F.3d 155, 157 (4th Cir. 1994), the Court of Appeals for the Fourth Circuit held that the automatic stay of 11 U.S.C. § 362(a) is violated when a depository institution places an administrative hold on a bankruptcy debtor's deposit account, while seeking relief from the automatic stay to exercise its right of setoff. CUNA has an interest in redressing the burden that the Court of Appeals' decision places upon its affiliates: thousands of credit unions chartered under the laws of the United States, and the several states.

Credit unions are fundamentally different from banks. National banks and state-chartered banks are for-profit entities owned by their respective stockholders. Banks are permitted to accept deposits from customers (who may or may not be stockholders of the banks). The relationship between a bank and its depositor-customer is a debtor/creditor relationship.[2] The common law right of setoff is applicable to the relationship of a bank and its depositor-customer.[3]

Federal and state-chartered credit unions are member owned, not-for-profit financial cooperatives. Federal credit unions and most state-chartered credit unions do

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[2] The earnings received by the bank depositor-customer are interest.

[3] *See* the authorities and discussion set forth on pages 33 and 34 of the Petition For A Writ of *Certiorari*.

not accept deposits from their member-customers, but rather issue shares in the institution (all member-customers are owners of the credit union).[4] The relationship between such credit unions and their member-customers is an equity relationship, 12 U.S.C. § 1757(6),[5] and not a debtor/creditor relationship. The strict common law right of setoff is not applicable to the relationship between credit unions and their member-customers.[6] Because of this fact, Congress and the states have provided statutory liens that attach to shares owned by member-customers and which secure obligations owing to the credit unions. By enacting the Bankruptcy Code, Congress did not repeal or otherwise limit these liens. In addition, credit unions include in their lending documents consensual liens in which the member-customers grant to the credit unions security interests in the members' shares to secure obligations owing to the credit unions. These liens distinguish the credit union community from other types of lenders whose interests are represented in this case.

Federal and state-chartered credit unions are authorized to make loans to their member-customers, secured

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[4] A few states (Georgia and Kansas) by statute permit state chartered credit unions to accept deposits in addition to offering shares.

[5] The earnings received by the credit unions' member-customers are dividends.

[6] In the few states that permit the acceptance of deposits by credit unions, the strict common law right of setoff does exist, but for the overwhelming majority of federal and state-chartered credit unions the strict common law right of setoff does not exist.

by the shares owned by the member-customers.[7] Many credit unions make these share loans at reduced interest rates and make a number of these loans to member-customers who are marginally creditworthy. These type loans enable member-customers who are marginally creditworthy to obtain credit and to improve their credit ratings. In addition to share loans, many credit unions, like banks, also offer their member-customers credit card accounts secured by their shares in the credit union. These accounts typically have low interest rates, and a number of these accounts are made available to member-customers who are marginally creditworthy. The Court of Appeals' decision in *Strumpf* will have an adverse impact on credit union share-secured lending and secured credit card accounts offered by credit unions to the detriment of consumers who are marginally creditworthy.

Unlike banks, federal credit unions are without statutory restrictions on where they can operate. Many credit unions currently have branches in or do business in more than one state. In fact, federal credit unions have had the ability to engage in interstate credit union operations since the enactment of the Federal Credit Union Act in 1934, 12 U.S.C. § 1751 *et seq*. The Court of Appeals' decision will have an adverse impact on interstate credit union operations, given the diversity of opinions and conflict among the circuits and among the various district and bankruptcy courts.

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[7] Unlike banks, credit unions by statute are permitted to make loans only to their member-customers.

CUNA is in a unique position to address the serious negative consequences of the *Strumpf* holding for federal and state-chartered credit unions as they impact the credit unions' federal and state statutory liens, consensual liens, share-secured loans and secured credit card accounts as well as interstate credit union operations.

II. SUMMARY OF ARGUMENT

The Court of Appeals' decision is contrary to both the language and the policies underlying the Bankruptcy Code as articulated in the Petition for Writ of *Certiorari*. Furthermore, the Court of Appeals erroneously ignored the prerequisite in 11 U.S.C. § 363(c)(2) that the debtor seek bankruptcy court permission prior to using cash collateral in the absence of creditor consent and the further requirement to provide adequate protection to the creditor.

The Court of Appeals' decision effectively deprives federal and state-chartered credit unions (that are fundamentally different from banks) of their federal and state statutory liens (property rights given to them by the Federal Credit Union Act or state statute) as well as consensual liens, in violation of the Takings Clause of the Fifth Amendment to the Constitution.

The Court of Appeals' decision will have the effect of severely restricting or eliminating two types of consumer secured lending that have been sources of credit for consumers who are marginally creditworthy. This conflicts with the purposes of the Federal Credit Union Act.

The *Strumpf* decision will adversely impact the interstate operations of federal credit unions (as well as state-chartered credit unions) which have been empowered by Congress to conduct interstate credit union operations since 1934. This decision accordingly conflicts with another purpose of the Federal Credit Union Act.

The secured rights of credit unions (and banks) must be protected and balanced by the Courts, as intended by Congress. The Court should grant the Petition for Writ of *Certiorari* for the reasons addressed in Petitioner's brief along with the reasons propounded in the *amici* filed by NationsBank, N.A. (Carolinas), NationsBank, N.A. and the First National Bank of Maryland as well as the *amici* filed by the American Bankers Association and by CUNA in order to correct the manifast injustice of the complete loss of collateral protection and to avoid the long-term consequences of inconsistent laws on national lending institutions and on the long-term availability of credit to certain consumer debtors.

III. ARGUMENT

A. The *Strumpf* decision is contrary to both the language and the policies underlying the Bankruptcy Code.

Petitioner's Brief assiduously addresses the arguments in favor of the Court granting the request for hearing the petition. These arguments accurately address the split in authority on the issue of lenders', including credit unions', rights to exercise their security interests as well as state and federal lien rights, in cash on deposit and the gross injustice done to the rights of creditors by

virtue of the Court of Appeals' decision. Petitioner's brief accurately addresses the Court of Appeals' failure to consider the interplay between the following sections of the Bankruptcy Code:[8] 11 U.S.C. §§ 362(a)(7), 542(b), 363(a), 506(a) and 553. The Court of Appeals only considered 11 U.S.C. § 362. This failure to consider the interplay among all of the statutes of the Bankruptcy Code constitutes reversible error.

In adopting and incorporating Petitioner's argument and those arguments propounded by the other *amici* in this case, CUNA further shows to the Court that the Bankruptcy Code at 11 U.S.C. § 363 requires that a debtor provide adequate protection to a lender prior to being given authorization to use cash collateral. "[C]ash collateral" means cash, . . . deposit accounts, . . . or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." 11 U.S.C. § 363(a). The debtor may not use cash collateral unless the entity that has an interest in such cash collateral consents; or the court, after notice and hearing, authorizes such use. 11 U.S.C. § 363(c)(2). The plain meaning of this provision is that the bankruptcy court may only allow such use of cash collateral upon the provision of adequate protection to the lender for its interest in the collateral. Strumpf never sought court permission to use the bank's cash collateral and the courts below completely ignored this requirement, which applies to Chapter 13 cases. *See, Dunlap v. Cash America Pawn of Nashville (In re Dunlap)*, 143 B.R. 859 (Bankr. M.D.Tenn. 1992), *rev'd on other grounds*, 158 B.R. 724 (M.D.Tenn. 1993); *Brown v.*

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[8] 11 U.S.C. § 101 *et seq.*

The Evanston Bank (In re Brown), 106 B.R. 546 (Bankr. N.D.Ill. 1989), *rev'd on other grounds*, 126 B.R. 767 (N.D.Ill. 1991); *In re Ingle*, 91 B.R. 27 (Bankr. E.D.Mich. 1988); *In re Ford*, 78 B.R. 729 (Bankr. E.D.Pa. 1987) and *Lee v. Schweiker (In re Lee)*, 25 B.R. 135 (Bankr. E.D.Pa. 1982).

B. The *Strumpf* decision deprives federal and state-chartered credit unions of their statutory and consensual liens without due process in violation of the Fifth Amendment of the Constitution.

The Fifth Amendment of the United States Constitution provides, in part, that "no person shall . . . be deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use, without just compensation."[9] If the Court of Appeals decision in *Strumph* is correct, Congress has, by enacting 11 U.S.C. § 362(a), effected a "taking" through governmental action which goes beyond mere regulation.

The rights of credit unions to intangible property (in the nature of their liens on share accounts) are eviscerated by the Court of Appeals refusal to give effect to the plain meaning of other, interrelated statutes in the Bankruptcy Code, most notably 11 U.S.C. § 363(c)(2). This isolated reading of Section 362(a) without reference to or explanation of the requirements of § 363(c)(2) leads to a "taking" of credit union liens.

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[9] U.S.C.A. Const.Amend. 5.

The applicability of the Taking Clause to intangible properties, such as liens, has historically been dependent upon legal recognition by an independent source of law.[10]

Federal credit unions are governed by federal law, codified at 12 U.S.C. § 1751 *et seq*. Congress has expressly provided these federal credit unions the right to a security interest in funds in members' share accounts at the credit unions, to the extent of loans made. 12 U.S.C. § 1757(11) provides that "A Federal Credit Union . . . shall have power . . . to impress and enforce a lien upon the shares and dividends of any member, to the extent of any loan made to him and any dues or charges payable by him". State-chartered credit unions are likewise given special statutory liens in almost all of the states. In addition, member-customers of federal and state-chartered credit unions often grant to the credit unions consensual liens on their shares to secure their loan obligations.[11]

Credit union liens are not unlike other intangibles which this Court has found to constitute "property" for the purposes of the Fifth Amendment's Taking Clause.[12]

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[10] *See, e.g., Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980).

[11] Furthermore, the common law right of setoff acknowledged by Congress in 11 U.S.C. §§ 542(b) and 553 is likewise a property interest of banks and suffers the same fate under the Court of Appeals' decision.

[12] *See, e.g., Ruckelshaus v. Monsanto, Co.*, 467 U.S. 986 (1984) (trade secrets protected by Taking Clause); *Armstrong v. United States*, 364 U.S. 40, 44, 46 (1960) (materialman's lien provided for under state common law protected); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 596-602 (1935) (real estate lien protected).

Intangibles delineated by statutory or common law as valid property interests have been furnished the shelter of the Taking Clause since the case of *United States v. General Motors, Corp.*,[13] in which this Court interpreted the language of the Taking Clause to encompass those rights related to property, to wit, possession, use and disposition, rather than mere protection of tangible property. Credit union liens share many of the characteristics that this Court has historically considered when addressing the applicability of the protection of the Taking Clause to intangible properties, and are therefore entitled to comparable treatment.

While it is true that this Court has never articulated a brightline test for determining whether a taking will occur as a result of the administration of a statute or regulation, several factors have been recognized as significant to the inquiry.

In *PruneYard Shopping Center v. Robins*,[14] this Court identified numerous factors which would be accounted for in determining whether governmental action has gone beyond "regulation" and effects a "taking." These factors included: "the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations." The existence of statutory and consensual liens certainly provide the degree of reasonable investment-backed expectation contemplated by the Court in *PruneYard*.[15] Credit unions have long

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[13] 323 U.S. 373, 377-378 (1945).

[14] 447 U.S. at 83 (1980).

[15] *Id.*

relied upon the validity of the statutory language and consensual agreements in assessing the risk of financial transactions. The explicit assurances provided for in these statutory schemes and private contracts form the basis of a reasonable investment-backed expectation.[16]

The Court of Appeals' decision, therefore, threatens to substantially interfere with the property interests of credit unions. The consequences of the decision will be to trigger countless violations of the Fifth Amendment if not reversed by this Court. The decision will effectuate this outcome by jeopardizing the statutory and consensual liens upon which credit unions depend in order to provide lower-interest financing to consumers of poor or marginal creditworthiness. Absent the authority to freeze an account, the bankrupt debtor is free to withdraw the funds, thus dispossessing the credit union of the dominion and control required by law to enforce the lien.

Hence, the inevitable impact of the Court of Appeals' decision will be to render future implementation of § 362(a) of the Bankruptcy Code[17] an unconstitutional taking. The lower court, in its legal reasoning, disregarded due process considerations in favor of statutory interpretation. This approach ignores the economic

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[16] Actual governmental acquisition of the property in question is not necessary to constitute a taking. In the landmark decision of *Pennsylvania Coal Co. v. Mahon*, this Court focused with equal scrutiny on the deprivation of the former individual owner rather than the transfer of a right or interest to the government or a third party. The divestiture of a credit union's lien rights is exemplary of such hardship.

[17] 11 U.S.C. § 101 *et seq.*

impact the decision will immediately have upon lending institutions and their consumer borrowers.

Furthermore, adequate compensation for such takings has not been provided for in either the Bankruptcy Code[18] or the Federal Credit Union Act.[19] The sole remedy available to the credit union in this situation is to pursue the individual debtor-member, who is shielded by the Bankruptcy Code, itself.

Consequently, credit unions will be equipped with no remedy at law to address such takings.[20] This violates the principles of fairness and equality representative of our judicial process and embodied within the Constitution. The Bankruptcy Code balances and protects the property interests of both debtors and secured creditors as demonstrated in the Petition for Writ of *Certiorari*. This Court can avoid the unconstitutional result reached by the Court of Appeals by reversing the decision and adopting the position articulated by the Petitioner in its Petition for Writ of *Certiorari*.

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[18] 11 U.S.C. § 101 *et seq.*

[19] 12 U.S.C. § 1751 *et seq.*

[20] It is notable that the judicially crafted "public use exception" to the Takings Clause is not applicable to credit union liens. Although property need not be put to use for the general public in order for a taking to fall squarely within the gamut of the public use exception, it is evident that the debtor, alone, is free to consume the capital. See generally, *Berman v. Parker*, 348 U.S. 26 (1957); *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). There is no conceivable public nature to such a taking.

C. The *Strumpf* decision will have the effect of severely restricting or eliminating two types of consumer secured lending that have been sources of credit for consumers who are marginally creditworthy, thereby conflicting with the purposes of the Federal Credit Union Act.

A federal credit union is defined as "a cooperative association organized in accordance with the provisions of this chapter for the purpose of promoting thrift among its members and creating a source of credit for provident and productive purposes", 12 U.S.C. § 1752(1). In accordance with their purpose federal credit unions and many state-chartered credit unions offer to their members loans that are secured by a security interest granted by the members in the shares in their share accounts as well as credit card accounts that are secured by the members' shares. Many members who are marginally creditworthy obtain these type loans and credit card accounts from their credit unions. These type loans and credit card accounts enable member-customers who are marginally creditworthy to improve their credit ratings as they are repaid. The Court of Appeals' decision will adversely impact these type loans and credit card accounts. The decision is not just limited to checking accounts and the right of setoff but will apply to any possessory lien held by a credit union or a bank whether created by statute or contract on any type of share or deposit account. The Court of Appeals' decision will force credit unions to curtail lending, even on a share secured basis, to member-customers who are marginally creditworthy. The purpose articulated in the Federal Credit Union Act and quoted above will be thwarted by the Court of Appeals' decision.

The adverse impact the Court of Appeals' decision will have on secured credit card accounts offered by banks and credit unions is sufficiently discussed in the *amicus curiae* brief filed by the American Bankers Association. CUNA supports the position advanced therein as it pertains to the adverse impact of the Court of Appeals' decision on secured credit card accounts.

D. The *Strumpf* decision will further the conflict among jurisdictions that adversely impacts the interstate operations of federal credit unions (as well as state-chartered credit unions).

Federal credit unions have had the ability to engage in interstate credit union operations since the enactment of the Federal Credit Union Act in 1934, 12 U.S.C. § 1752(9). The Court of Appeals' decision will continue the negative impact the conflict among the jurisdictions has had on the interstate operations of credit unions. The arguments set forth in the *amici curiae* brief filed by NationsBank, N.A. (Carolinas), NationsBank, N.A., and the First National Bank of Maryland addressing the adverse impact the Court of Appeals' decision will have on interstate banking also sufficiently address the adverse impact the Court of Appeals' decision will have on interstate credit union operations. CUNA supports the position advanced therein as it pertains to the adverse impact of the Court of Appeals' decision on interstate credit union operations and interstate banking.

IV. CONCLUSION

For these reasons, Credit Union National Association, Inc. respectfully requests that this Court grant the Petition for Writ of *Certiorari*.

Respectfully submitted this 8th day of March, 1995.

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,
Petitioner,
vs.
DAVID STRUMPF,
Respondent.

BRIEF OF BANKAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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No. 94-1340

In the Supreme Court

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OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,
Petitioner,
vs.
DAVID STRUMPF,
Respondent.

BRIEF OF BANKAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

INTEREST OF THE AMICUS CURIAE

BankAmerica Corporation ("Amicus") is a bank holding company which, through its subsidiaries, transacts banking business on a national basis. Amicus currently operates banks which provide deposit account services in 13 states. With the recent passage of legislation which virtually lifts restrictions on interstate banking, Amicus expects that multi-state deposit account services will be offered by an ever greater number of national banks. Amicus therefore has a great stake in insuring that the Federal Bankruptcy Law is correctly and uniformly interpreted throughout the United States.

Pursuant to Rule 37.2 this brief is submitted prior to the consideration of the Petition for Writ of Certiorari with the

written consent of the parties, as evidenced by the correspondence appended to the brief.

The judgment of the United States Court of Appeals for the Fourth Circuit is manifestly incorrect. If the Fourth Circuit's judgment is allowed to remain the law, Amicus and deposit takers in the Fourth Circuit will be required to forego statutorily granted property rights without hearing or other due process of law in order to avoid liability for contempt. This result conflicts with constitutional principles and the Bankruptcy Code itself.

Because of the substantial impact on the banking community that this case creates, Amicus believes that its views on the proper interpretation of the law may be of assistance to the Court's consideration of this case.

INTRODUCTION AND SUMMARY OF ARGUMENT

The United States Court of Appeals for the Fourth Circuit has effectively stood the Bankruptcy Code[1] on its head by misinterpreting a procedural device so as to invalidate a substantive property right. The Fourth Circuit mistakenly found a depository bank's administrative hold on a bankruptcy debtor's demand deposit account "tantamount to the exercise of a right of setoff" and thus in violation of the automatic stay of § 362(a)(7). *In re Strumpf*, 37 F. 3d 155, 158 (4th Cir. 1994). The effect of the Fourth Circuit's error is to deny banks and other depository institutions a substantive property right without notice or opportunity to be heard, thereby denying due process of law as guaranteed under the Fifth Amendment to the United States Constitution.

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[1]The United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*, referred to hereafter as the Bankruptcy Code. All statutory references are to the Bankruptcy Code unless otherwise indicated.

Such was not the intention of the drafters of the Bankruptcy Code. To the contrary, the drafters established a careful balance of rights and duties which ensure that before substantive property rights can be impaired, the parties must be afforded a hearing and adequate safeguards to protect their property interests.

It is essential to keep two incontrovertible concepts firmly at hand. First, a demand deposit account is merely a payable on the books of the depository, not a discrete fund of a depositor's money held in trust. *Keller v. Fredericktown Sav. Inst.*, 66 A. 2d 924, 925 (Md. 1949); *Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold*, 608 A. 2d 1194, 1201 (Md. App. 1992). Second, the Bankruptcy Code makes no distinction between the setoff rights of a depository and those of any other creditor. Rather, it is the courts which have created unwarranted distinctions between classes of creditors holding setoff rights.

The issue of setoff is perhaps most focused with depositories due to the ease with which demand deposit accounts are accessed. Unique among creditors who may assert setoff rights, the depository is faced with an immediate demand for turnover of funds through the presentation of a draft or check by the debtor. The depository must then either honor the check, thereby losing the right to setoff mutual obligations, or dishonor the check and preserve such rights. If the second course is chosen the depository "freezes" or holds the account. This administrative hold properly should not be viewed as an act but as a refusal to act in the face of an unlawful attempt by the debtor to withdraw funds.

The Fourth Circuit's opinion creates a false dilemma, *i.e.*, whether an administrative hold imposed to preserve the right of setoff recognized by § 553(a) violates the automatic stay against setoffs accorded to the debtor under § 362(a)(7). This dilemma is false because it has an explicit statutory answer found at § 542(b), a provision rele-

gated to a mere footnote in the Fourth Circuit's opinion. *Strumpf*, 37 F. 3d at 157, fn.*

Amicus will demonstrate that the language of the Bankruptcy Code — together with general principles of statutory interpretation — establish beyond any doubt that Congress did not intend to deny banks and other depository institutions the substantive right of setoff without the due process safeguards mandated by the Fifth Amendment to the Constitution.

The statutory analysis must begin at § 553(a), which specifically preserves the right of a creditor to offset a mutual debt, subject to the limitations therein contained. This substantive right protected by § 553(a) must then be tested by its companion provisions found at §§ 506(a), 542(b), 362(a)(7) and 363(e). This framework of statutory rights and obligations balances the rights of debtors and depositories and accords due process to all.

ARGUMENT

THE FOURTH CIRCUIT'S INTERPRETATION OF § 362(a)(7) OF THE BANKRUPTCY CODE RESULTS IN A TAKING OF PROPERTY WITHOUT CONSTITUTIONALLY PROTECTED DUE PROCESS OF LAW

The Fourth Circuit has interpreted § 362(a)(7) to prohibit an "administrative freeze" which has as its purpose the preservation of the right of setoff recognized by § 553(a). It is respectfully submitted that the Fourth Circuit erred in its interpretation, with the result that Petitioner was denied its property without hearing and without due process of law.

Section 553(a) provides, in relevant part, as follows:

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .

Section 553(a) recognizes the right of setoff. Section 506(a) goes further. Section 506(a) accords the status of a secured creditor to a party holding rights of setoff, to the extent of the amount subject to setoff.[2] The legal effect of such status is that the property subject to the setoff cannot be used, sold or leased unless the Court, with or without a hearing, determines that such property interest is adequately protected.[3]

Thus, until a debtor accords the holder of setoff rights adequate protection of its rights, the debtor may not lawfully use the property absent the consent of such party. This does not mean, however, that the party holding setoff rights may enforce them. The automatic stay of § 362(a)(7) acts as a counterbalance, and restrains setoff until the Court grants relief from stay to effect the setoff.

The Fourth Circuit balanced § 553 against § 362 and erroneously ruled that the stay against setoff compelled

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[2]Section 506(a), as relevant, provides:

> An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.

[3]Section 363(e), as relevant, provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

Petitioner to turn over the funds in debtor-Respondent's checking account to Respondent, thereby destroying Petitioner's setoff rights, on pain of contempt. Thus, in effect, the stay provision was used to trump Petitioner's substantive setoff rights, and allowed Respondent access to funds which it was legally unable to use without affording adequate protection.

A. THE FOURTH CIRCUIT'S INTERPRETATION VIOLATES THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT TO THE CONSTITUTION

The Fifth Amendment declares that no person shall be "deprived of life, liberty, or property, without due process of law . . . ." The Fourth Circuit's opinion creates a violation of this principle.

This Court is constrained to interpret the Bankruptcy Code so as to uphold its constitutionality. In *Edward J. DeBartolo Corp. v. Florida Gulf Coast Building and Construction Trades Council*, 485 U.S. 568, 575, 108 S. Ct. 1392, 99 L. Ed. 2d 645 (1988), this Court reaffirmed that "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress." The *DeBartolo* Court characterized this tenet of statutory construction as a "cardinal principle," which "has for so long been applied by this Court that it is beyond debate." *Id.* *See also United States v. Monsanto*, 491 U. S. 600, 611, 109 S. Ct. 2657, 105 L. Ed. 2d 512 (1989); *NLRB v. Catholic Bishop of Chicago*, 440 U. S. 490, 500, 99 S. Ct. 1313, 86 L. Ed. 2d 533 (1979). In defiance of this "cardinal principle," the Fourth Circuit construed the Bankruptcy Code so as to create a violation of the Fifth Amendment.

The Fourth Circuit could have avoided the Fifth Amendment issue entirely by considering § 542(b), which provides:

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.* (emphasis supplied).

Instead, the Fourth Circuit's opinion simply ignores the provisions of § 542(b) to reach its erroneous result. However, were the Bankruptcy Code to be interpreted to eviscerate the right of setoff, it would constitute a taking prohibited by the Fifth Amendment.

This Court addressed the interplay between the Bankruptcy Code and the Fifth Amendment in the case of *U. S. v. Security Industrial Bank*, 459 U. S. 70, 103 S. Ct. 407, 74 L. Ed. 2d 235 (1982), in which the Court held that the Bankruptcy Code cannot be construed so as to destroy the property rights of secured creditors. The holder of a setoff right recognized by § 553 of the Bankruptcy Code is accorded the legal status of a secured creditor and holds a secured claim to the extent of the amount subject to setoff. *See* § 506(a); *Matter of Lawndale Steel Co.*, 155 Bankr. 990, 992 (Bkrtcy. N.D. Ill. 1993). The issue in *Security Industrial* was whether § 522(f) of the Bankruptcy Code could be applied to allow a debtor to avoid a non-purchase money, non-possessory security interest in personal property pre-existing the effective date of the Bankruptcy Code. In order to prevent a taking under the Fifth Amendment, the Court declined to apply this statute retrospectively. In the course of its discussion, the Court examined the relationship between the bankruptcy statutes and the Fifth Amendment, and noted that if a bankruptcy statute destroys property

rights, the statute cannot be defended on "rational basis" grounds:

> It may be readily agreed that § 522(f)(2) is a rational exercise of Congress' authority under Article I, Section 8, Clause 4, and that this authority has been regularly construed to authorize the retrospective impairment of contractual obligations .... Such agreement does not, however, obviate the additional difficulty that arises when that power is sought to be used to defeat traditional property interests. The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation .... Thus, however "rational" the exercise of the bankruptcy power may be, that inquiry is quite separate from the question whether the enactment takes property within the prohibition of the Fifth Amendment. 459 U. S. at 74-75 (citations omitted).

In reaching its decision the Court carefully distinguished between the rights of secured and unsecured creditors, rejecting the argument of the government that a secured party's rights are deserving of no greater protection under the takings clause than traditional contract rights. *Id.* at 75. The Court stated: "However 'bankruptcy principles' may speak to this question, our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the same creditor in the collateral." *Id.*

The Court then discussed the cases establishing that the destruction of a lien is a taking. The government had taken the position that the bankruptcy law had simply imposed a general economic regulation which in effect transferred the property interest from a private creditor to a private debtor, and therefore was not a taking because the government had not acquired for itself the property in question. *Id.* at 78, 79.

The Court was unimpressed, finding that the government's argument was a distinction without a difference. The Court refused to countenance the stripping of a secured creditor's lien rights without affording that secured creditor due process of law.

The analysis in *Security Industrial* applies forcefully to the facts of this case. If § 362(a)(7) is so broadly interpreted as to permit a debtor to take and spend funds subject to the right of setoff, and if § 542(b) is ignored, then the right of setoff becomes meaningless as a practical matter. If the insolvent debtor is permitted immediate and unfettered access to its funds, the funds will be irretrievably dissipated and the bank's property rights as secured creditor will have been destroyed — unconstitutionally taken — by the Bankruptcy Code. *See In re George Ruggiere Chrysler-Plymouth*, 727 F. 2d 1017, 1019 (11th Cir. 1984) ("the Bankruptcy Court cannot allow the secured interest to be threatened by improper use of cash proceeds").

That is precisely what Congress intended to prevent — as a matter of constitutional principle and as a matter of policy — when it enacted the adequate protection standards set forth in § 361:

> The concept [of adequate protection] is derived from the fifth amendment protection of property interests. *See Wright v. Union Central Life Ins. Co.*, 311 U. S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555 (1935). It is not intended to be confined strictly to the constitutional protection required, however. The section, and the concept of adequate protection, is based as much on policy grounds as on constitutional grounds. *Secured creditors should not be deprived the benefit of their bargain.* ...

H.R. Rep. No. 95-595, 95th Cong., 1st Sess., *reprinted in* U.S.C.C.A.N. 5787, 6295 (emphasis supplied). *See also In*

re Born, 10 Bankr. 43, 48 (Bkrtcy. S.D. Tex. 1981) ("The very heart of the concept of adequate protection is to assure the secured creditor that as the bankruptcy procedures unfold he will not be faced with a decrease in the value of his collateral").

As demonstrated above, there is no reason to reach this conflict between Fifth Amendment and bankruptcy law, because when Congress enacted the Bankruptcy Code it specifically protected setoff rights against such an unconstitutional taking. The view of the Fourth Circuit should be rejected, and the Bankruptcy Code should be interpreted in a manner consistent with the Fifth Amendment.

B. THE FOURTH CIRCUIT'S STATUTORY ANALYSIS IS IN ERROR

The Fourth Circuit characterized the competing mandates of §§ 553 and 362 as the "banker's dilemma" [*Strumpf*, 37 F. 3d at 158] because a banker would be faced with the choice of protecting its property interests by relying on § 553 or being held in contempt by virtue of § 362(a)(7). It is respectfully submitted, however, that this is a false dilemma, created by a misreading of the Bankruptcy Code itself.

In unambiguous statutory language, § 542(b) excuses a turnover of property by one holding setoff rights. This specific statutory language was given no consideration by the Fourth Circuit. In fact, its entire discussion of § 542(b) was relegated to a single footnote with no explanation offered as to why it was not the controlling statutory law. *See Strumpf*, 37 F. 3d at 157 n.*.

Basic principles of statutory construction require courts to interpret statutes in accordance with their plain meaning. "In determining the scope of a statute, we look first to its language. If the statutory language is unambiguous, in the

absence of 'a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive.' " *United States v. Turkette*, 452 U. S. 576, 580, 101 S. Ct. 2524, 69 L. Ed. 2d 246 (1981), *quoting Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U. S. 102, 108, 100 S. Ct. 2051, 64 L. Ed. 2d (1980). The Fourth Circuit should have read and interpreted Section 542(b) to mean what it plainly says.

Instead, by summarily dismissing the clear authority of § 542(b), the Fourth Circuit reached exactly the wrong conclusion. For whatever its reasons, it substituted its views for the Congressional views expressed in § 542(b) despite the plain language of the statute. It read the language of § 362(a)(7), which stays setoff, as mandating a turnover of the funds subject to setoff where no such mandate appears and where the statutory mandate is exactly to the contrary.

As Petitioner makes abundantly clear in its Petition For A Writ of Certiorari, pp. 40 and 41, setoff is a multi-stage process requiring both the intent to setoff and an act which gives meaning to that intent. Recognizing this, the drafters of the Bankruptcy Code balanced the automatic stay provisions against the turnover statutes to preserve the *status quo* and the property rights of the depository until a hearing could be conducted. The Fourth Circuit chose to ignore the statutory framework governing preservation of setoffs in § 542(b), thereby reaching the remarkable proposition that Petitioner's *compliance* with § 542(b) resulted in a *violation* of § 362(a)(7) and subjected Petitioner to contempt and sanctions. This Court should return the law of the Fourth Circuit to the uniform federal bankruptcy law enacted by Congress by giving effect to the plain meaning of the Bankruptcy Code's provisions.

CONCLUSION

Banks and other depositories are not the only creditors who hold rights of setoff recognized by the Bankruptcy Code, but they are uniquely affected by the Fourth Circuit's ruling. Other creditors who may have rights of setoff are not required by the Fourth Circuit's opinion to forfeit their rights in order to avoid contempt. *The opinion appears to apply only to deposit accounts.*

A debtor will attempt to access funds in a bank account merely by presenting a check or other instrument to the bank, making the issue an immediate one. This ease of access makes the issue one of great concern to the banking industry and, perhaps unavoidably, has led courts astray in their analysis of the respective rights and obligations of the debtor and the depository.

There is no good solution other than the statutory solution afforded by § 542(b). In order to protect its rights the bank or other depository should be able to place an administrative freeze on the funds, which will preserve the *status quo*. The debtor will be allowed the opportunity to seek lawful use of the funds under § 363, and the depository will be able to seek relief from stay under § 362. In this manner the constitutional and economic rights of the parties are protected and uniformity in banking practices is assured. For the foregoing reasons Amicus urges that this Court accept

the Petition For Writ Of Certiorari and reverse the decision of the Fourth Circuit.

Respectfully Submitted

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(Counsel of Record)
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MICHAEL J. HALLORAN,
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600 WASHINGTON AVENUE
TOWSON, MD 21204-3985

1460 G STREET N.W.
WASHINGTON, D.C. 20005-2001

March 1, 1995

JEFFERSON V. WRIGHT
410-385-3600

VIA FEDEX AND
FACSIMILE 415/622-8399

Harold R. Lichterman, Esquire
Senior Counsel
Bank of America NT&SA
Legal Department North #3017
555 California Street, 7th Fl.
San Francisco, California 94104

Re: Citizens Bank of Maryland, Petitioner
v. David Strumpf, Respondent
Case No.: 94-1340 (Pending in the
Supreme Court of the United States)

Dear Harold:

I am writing to confirm that our client in the above-referenced proceeding, Petitioner, Citizens Bank of Maryland, consents to the filing by the Bank of America (and/or any of its affiliates) of an amicus brief supporting the Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit filed by us in the Supreme Court of the United States on behalf of our client on February 6, 1995. To the extent necessary, you may consider this consent as having been provided directly by counsel of record on behalf of Citizens Bank, James R. Eyler.

Please let me know if you need anything further from me in connection with this letter.

Very truly yours,

Jefferson V. Wright

JVW/cr
cc: Daniel L. Rhoads, Esq.
James R. Eyler, Esq.

LAW OFFICES
OF
JOHN R. OWEN, JR.
AND ASSOCIATES, P.C.
1836 UNIVERSITY BLVD. STE. 902
HYATTSVILLE, MD 20783

(301) 445-2100
FAX (301) 445-6331

March 1, 1995

Harold Lichterman, Esquire
555 California St.
San Francisco, CA 94104

re: Citizens Bank v. Strumpf

Dear Mr. Lichterman:

To the extent that I may pending my admittance to the Supreme Court Bar I consent to your filing, on behalf of your client, an amicus brief in support of the Petition for Writ of Certiorari.

Thank you for your interest in this matter.

Yours truly,

John R. Owen, Jr.

LAW OFFICES
OF
JOHN R. OWEN, JR.
AND ASSOCIATES, P.C.
1030 UNIVERSITY BLVD., STE. 202
HYATTSVILLE, MD 20783

(301) 445-2100
FAX (301) 445-8331

March 1, 1995

Harold Lichterman, Esquire via fax (415) 622-8399
555 California St.
San Francisco, CA 94104

re: Citizens Bank v. Strumpf

Dear Mr. Lichterman:

I have misplaced your phone number. Mr. Culver provided me your address and fax number.

After much thought and consideration, I have decided to consent to your filing an amicus brief on behalf of your client in support of the Petition for Certiorari.

I apologize for any inconvenience this change may have caused.

With this fax I have enclosed a copy of my consent, on my letterhead, that I have mailed to you today by first class mail. If you wish this done another way, please give me call.

I look forward to meeting you when you come to Washington.

Yours truly,

John R. Owen, Jr.

Supreme Court, U.S.
FILED
MAY 11 1995
CLERK

No. 94-1340

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

JOINT APPENDIX

JAMES R. EYLER
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JOHN R. OWEN, JR.
(Counsel of Record)
JOHN R. OWEN, JR. AND
ASSOCIATES
1835 University Boulevard
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(301) 445-2100
Counsel for Respondent.

Washington, D.C. • THIEL PRESS • (202) 328-3288

PETITION FOR CERTIORARI FILED FEBRUARY 6, 1995
CERTIORARI GRANTED MARCH 27, 1995

48 pp

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CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

DATE	*DESCRIPTION*
January 25, 1991	Strumpf's Chapter 13 bankruptcy petition filed.
April 8, 1991	Bankruptcy court Order confirming Strumpf's Chapter 13 plan entered.
October 7, 1991	Citizens Bank of Maryland's motion for relief from automatic stay and for setoff filed.
October 9, 1991	Strumpf's motion to hold Citizens Bank of Maryland in contempt filed.
October 31, 1991	Strumpf's countermotion seeking release of administrative hold and turnover of funds filed.
November 21, 1991	Bankruptcy court Order finding Citizens Bank of Maryland in contempt and awarding sanctions entered.
November 21, 1991	Notice of appeal of bankruptcy court's Order finding bank in contempt and awarding sanctions filed by Citizens Bank of Maryland.
December 2, 1991	Bankruptcy court Order granting Citizens Bank of Maryland relief from the automatic stay and authorizing setoff entered.
December 23, 1991	Bankruptcy court Order for stay of enforcement of Order finding bank

	in contempt and awarding sanctions pending appeal entered.
March 30, 1992	Order from the U.S. District Court for the District of Maryland reversing the Order of the bankruptcy court finding Citizens Bank of Maryland in contempt and awarding sanctions entered.
April 29, 1992	Notice of appeal of district court's Order filed by Strumpf.
June 11, 1994	Bankruptcy court Order discharging Strumpf after completion of Chapter 13 plan entered.
October 13,1994	Order of the U.S. Court of Appeals for the Fourth Circuit reversing and remanding the Order of the district court entered.

APPENDIX A

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

CASE NO.

CHAPTER 13 PLAN

In re: DAVID STRUMPF

Debtor(s).

CHAPTER 13 PLAN

I. PROPERTY AND FUTURE EARNINGS.

The debtors submit the following property to the supervision and control of the Trustee: wages in the amount of $100.00 per month for 48 months.

II. CLASSIFICATION AND TREATMENT OF CLAIMS.

CLASS 1: Priority claim to pay attorneys fees in the amount of $500.00.

CLASS 2: Trustee's compensation as allowed.

CLASS 3: Allowed claims of unsecured creditors in the amount of $3,837.00 to be paid *pro-rata.*

III. OTHER PROVISIONS.

1. Payments by the Debtor will be made directly to the Trustee by the debtor beginning on or before February 28, 1991.

2. Regular monthly payments to Chrysler Corp. will be made outside the plan.

3. Debtor intends to surrender furniture to HRSI.

/s/ David Strumpf
Debtor

Dated: 1-24-91

/s/ John R. Owen, Jr.
John R. Owen, Jr.
Attorney for Debtors
1835 University Blvd., Ste. 232
Hyattsville, Maryland 20783
(301) 445-2100

APPENDIX B

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MARYLAND

10226 336 9140389-COURT A

CASE NUMBER 91-4-0389PM

IN RE: DAVID STRUMPF
8150 LAKECREST DRIVE #516

GREENBELT, MD 20770
SSN 084-10-4119

9140389
U S BANKRUPTCY COURT
451 HUNGERFORD DRIVE
FIFTH FLOOR
ROCKVILLE, MD 20850

ORDER FOR MEETING OF CREDITORS,
COMBINED WITH NOTICE THEREOF
AND OF AUTOMATIC STAYS

To the debtor, his creditors and other parties in interest:

An order for relief under title 11 U.S.C. chapter 13 having been entered on a petition filed by the above debtor(s) on: JAN 25, 1991

IT IS ORDERED, AND NOTICE
IS HEREBY GIVEN THAT:

A meeting of creditors pursuant to title 11 U.S.C. §341(a) shall be held at:

OFFICE OF THE U.S. TRUSTEE
51 MONROE STREET ROOM B
PLAZA WEST 5
ROCKVILLE, MD.

DATE
MAR. 15, 1991
TIME
11.00 A.M.

ADDRESSEE

9140389 – COURT - A
BANKRUPTCY COURT
451 HUNGERFORD DRIVE
FIFTH FLOOR
ROCKVILLE, MD 20850

The debtor shall appear in person at that time and place for the purpose of being examined.

YOU ARE FURTHER NOTIFIED THAT:

The meeting may be continued or adjourned from time to time by notice at the meeting without further written notice to creditors.

At the meeting the creditors may file their claims, examine the debtor, and transact such other business as may properly come before the meeting.

As a result of the filing of the petition, certain acts and proceedings against the debtor and his property are stayed as provided in 11 U.S.C. §362(a) and against certain codebtors as provided in 11 U.S.C. §1301. Significant parts of these sections are reproduced on the reverse side of this notice.

In order to have his claim allowed so that he may share in any distribution from the estate, a creditor must file a claim, whether or not he is included in the list of creditors filed by the debtor. Claims which are not filed on or before JUNE 13, 1991 will not be allowed, except as otherwise provided by law. A hearing on confirmation of the plan will be held ON MARCH 20, 1991 AT 2.00 P.M.

IF WRITTEN OBJECTIONS TO CONFIRMATION ARE FILED, A HEARING ON SUCH OBJECTIONS WILL BE HELD AT THE TIME OF THE CONFIRMATION HEARING.

IF CHAPTER 13 PLAN IS AMENDED, A HEARING ON SUCH AMENDMENT WILL BE HELD AT THE TIME OF THE CONFIRMATION HEARING.

ANY QUESTIONS REGARDING THIS NOTICE MAY BE DIRECTED TO THE TRUSTEE, THOMAS LACKEY, 4325 NORTHVIEW DRIVE, BOWIE, MD. 20716. TELEPHONE NO. 301-390-6400.

ATTORNEY FOR DEBTOR – JOHN R. OWEN, JR.,
301-445-2100 1835 UNIVERSITY BLVD
SUITE 232, HYATTSVILLE, MD 20783

THE PLAN PROPOSES PAYMENTS TO THE TRUSTEE OF $100.00 MONTHLY

FILE CLAIM WITH ATTACHMENTS,
IF ANY, IN DUPLICATE WITH:

9140389 COURT – -A
U S BANKRUPTCY COURT
451 HUNGERFORD DRIVE
FIFTH FLOOR
ROCKVILLE, MD 20850

DATED FEBRUARY 26, 1991 BY THE COURT
AT ROCKVILLE, MD
PAUL MANNES
BANKRUPTCY JUDGE

CLAIMS LISTED BY THE DEBTOR

Secured	Priority	Unsecured	Total Debts
18,000.00		19,063.00	37,063.00

AUTOMATIC STAY

Section 362(a) (11 U.S.C. §362) provides that the petition:

". . . operates as a stay, applicable to all entities, of – –

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative or other proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien

secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor."

STAY OF ACTION AGAINST CODEBTOR

Section 1301(a) (11 U.S.C. §1301) provides that:

"After the order for relief a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless – –

(1) such individual become liable on or secured such debt in the ordinary course of such individual's business; or

(2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title."

APPENDIX C

[Filed APR 08, 1991]

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

Case No. 91-4-0389

Chapter 13

IN RE: David Strumpf

Debtor

ORDER CONFIRMING PLAN

The Debtor's plan filed on January 25, 1991 having been transmitted to creditors; and

The deposit, if any, required by the plan in the sum of $100.00 having been made; and

It having been determined after hearing on notice;

1. That the plan complies with the provisions of Chapter 13 of Title 11, U.S.C., and with other applicable provisions of the Bankruptcy Code;

2. That the filing fee and any other amount required to be paid before confirmation has been paid;

3. That the plan has been proposed in good faith and not by any means forbidden by law;

4. That the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor was liquidated under Chapter 7 of Title 11, U.S.C., on such date;

5. That each holder of an allowed secured claim provided for by the plan has accepted the plan; or that plan provides that the holders of such claims retain the liens securing such claims and the value, as of the effective date of the plan, of property to be distributed under the plan on account of each such claim is not less than the allowed amount of each such claim; or the debtor has surrendered the property securing such claims to each such holder; and

6. The debtor will be able to make all payments under the plan and to comply with the plan; it is

ORDERED, That the debtor's plan is confirmed; and it is further

ORDERED, That on the 20th day of March 1991, and on the 20th day of each succeeding month thereafter until further Order of the Court, the debtor shall pay to the Trustee, Thomas L. Lackey, Esquire, 4325 Northview Drive, Bowie, Maryland, 20716, the sum of $100.00.

Date: APR 08 1991

/s/ Paul Mannes
U.S. BANKRUPTCY JUDGE
United States Bankruptcy Court
for the District of Maryland

cc: Thomas L. Lackey, Esq., 4325 Northview Dr., Bowie, MD 20716; John R. Owen, Jr., Esq., 1835 University Blvd., Ste. 232, Hyattsville, MD 20783; and to David Strumpf, debtor, 8150 Lakecrest Dr., #516, Greenbelt, MD 20770.

ENTERED: APR 08 1991

APPENDIX D

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MARYLAND

BKNO: 91-4-0389

To: DAVID STRUMPF
8150 LAKECREST DR
#516
GREENBELT, MD
20770

NOTICE OF CLAIMS

The trustee has examined the proofs of claim filed in this case and objected to the allowance of such claims as appeared to be improper except where no purpose would have been served by such objection. After such examination and objections, if any, the trustee states that claims should be deemed allowed, or "not filed" as indicated below.

CREDITOR NAME	*CLAIM AMT*	*STATUS*
CHRYSLER CREDIT CORP 7885 WALKER DRIVE SUITE 410 GREENBELT, MD 20770	PAY DIRECT ACCOUNT # – INTEREST RATE: 0%	SECURED
HRSI P O BOX 7671 NORTH SUBURBAN IL 60128	PAY DIRECT ACCOUNT # INTEREST RATE: 0%	SECURED

CREDITOR NAME	*CLAIM AMT*	*STATUS*
SEARS, ROEBUCK & CO. 7023 ALBERT PICK ROAD GREENSBORO, NC 27409	1,798.58 ACCOUNT #54 50971 47640 5 INTEREST RATE: 0%	UNSECURED
WOODWARD & LOTHROP P O BOX 740933 DALLAS TX 75374	919.34 ACCOUNT #864 535 64 INTEREST RATE: 0%	UNSECURED
CITIZEN BANK OF MARYLAND % LOAN DEPARTMENT P O BOX 117 LAUREL, MD 20707	NOT FILED ACCOUNT # INTEREST RATE: 0%	UNSECURED
BANK OF NEW YORK (DE) % BECKET ETAL P O BOX 512 MALVERN, PA 19355	2,439.08 ACCOUNT # 5432 3534 0129 4426 INTEREST RATE: 0%	UNSECURED
VISA CENTER 201 MAIN STREET LAFAYETTE, IN 47901	NOT FILED ACCOUNT # INTEREST RATE: 0%	UNSECURED
FCC NATIONAL BANK 60 CHARLES LINDBERGH BLVD UNIONDALE NY 11553	7,970.53 ACCOUNT # 4250 407 076 832 INTEREST RATE: 0%	UNSECURED
PERPETUAL SAVINGS BANK P O BOX 1494 ALEXANDRIA, VA 22314	NOT FILED ACCOUNT # INTEREST RATE: 0%	UNSECURED

CREDITOR NAME	*CLAIM AMT*	*STATUS*
HOUSEHOLD FINANCE CORP. P O BOX 2688 CHESAPEAKE, VA 23327	356.78 ACCOUNT # 519100 06 767840 INTEREST RATE: 0%	UNSECURED
TOTAL CLAIM AMOUNT:	13,484.31	

ATTORNEY FOR DEBTOR
JOHN R. OWEN, JR.
1835 UNIVERSITY BLVD
SUITE 232
HYATTSVILLE MD 20783

The trustee hereby notifies the debtor and counsel that the claims indicated as filed above are allowed under Section 502 of the U.S. Bankruptcy Code unless an objection to a claim is filed with this Court and sustained.

DATED: 09/17/91

THOMAS L. LACKEY,
CH. 13 TRUSTEE
4325 NORTHVIEW DRIVE
BOWIE, MD 20716

cc: Attorney for Debtor
Debtor

APPENDIX E

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

Case No. 91-4-0389PM
Chapter 13

Motion No. _____

IN RE:

DAVID STRUMPF

Debtor

* * * * * * * * *

CITIZENS BANK OF MARYLAND

Movant

v.

DAVID STRUMPF

Respondent

MOTION FOR RELIEF FROM AUTOMATIC STAY AND FOR SETOFF

Citizens Bank of Maryland (hereinafter "Bank") Movant, by Hartman and Crain, C. Edward Hartman III and Matthew A. Egeli, its attorneys, moves, pursuant to 11 U.S.C. §362(d) and Bankr. Rules R.4001(a) and 9014, for relief from the automatic stay and for setoff, and in support thereof states as follows:

1. The debtor is obligated to the Bank under an unsecured consumer loan note, which is in default.

2. By virtue of funds in the debtor's account with the Bank in an amount equal to the above-referenced debt,

there exist mutual and mature debts between the parties giving rise to the common law right of setoff.

WHEREFORE, the Bank request that the Court:

A. Issue an order granting the Bank relief from the automatic stay;

B. Issue an order authorizing the Bank to setoff the funds in checking account number 04261382 in the amount of Two Thousand Eight Hundred Seventy-Seven and 10/100 Dollars ($2,877.10) plus additional interest at the rate of $1.15 per diem from October 15, 1991 through the date of this Order, and attorney's fees of Three Hundred Eighty-Two and 58/100 Dollars ($382.58); and

C. Grant such other and further relief as the nature of this cause may require.

HARTMAN AND CRAIN

By: /s/ C. Edward Hartman III
C. Edward Hartman III

By: /s/ Matthew A. Egeli
Matthew A. Egeli
2660 Riva Road - Fourth Floor
Annapolis, Maryland 21401-7333
Telephones: 266-0505 (Annap.)
261-8513 (Wash.)
841-5204 (Balt.)

Attorneys for Citizens Bank of Maryland

Statement of Authorities

Memorandum in Support of Motion for Relief from Automatic Stay and for Setoff.

[Certificate of Service Omitted in Printing]

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

[Caption Omitted in Printing]

MEMORANDUM IN SUPPORT OF MOTION FOR RELIEF FROM AUTOMATIC STAY AND FOR SETOFF

Citizens Bank of Maryland (hereinafter "Bank"), Movant, by Hartman and Crain, C. Edward Hartman III and Matthew A. Egeli, its attorneys, files this Memorandum in Support of its Motion for Relief From Automatic Stay and for Setoff.

FACTS

The facts relevant to the present Motion are as follows:

1. The debtor filed the petition which initiated this case on January 25, 1991.

2. The Debtor has checking account number 04261382 with the Bank. At that time, the account contained $11,279.86.

3. On November 28, 1989, the Bank loaned the Debtor the principal amount of Five Thousand Sixty-Eight and 75/100 Dollars ($5,068.75) pursuant to an unsecured consumer loan note ("Note") whereby the Debtor promised and agreed to pay to the order of the Bank the principal sum plus interest at the annual rate of sixteen and one-half percent (16.5%), pursuant to the terms and conditions of the Note, a true and accurate copy of which is attached hereto as Exhibit A and incorporated herein by reference.

4. The Debtor has not made a payment on the Note since January 4, 1991.

5. The Note further provides for immediate acceleration of the amount due upon default and for the payment of attorney's fees equal to fifteen percent (15%) of the amount due upon referral of the matter to an attorney for collection.

6. The Note has been declared in default. The amount presently due on the Note is as follows:

Principal	$2,500.50
Interest (from 1/4/91 through 10/15/90)	$326.00
Attorney's Fees	$382.58
TOTAL:	$3,259.68

7. Interest continues to accrue on the principal amount set forth in the above paragraph at the rate of $1.15 per diem.

DISCUSSION

It is a well established general proposition under Maryland common law that a bank has the right to setoff a depositor's account against a mature indebtedness. *Mercantile-Safe Deposit and Trust Co. v. Delp and Chapel Concrete and Const. Co.*, 44 Md. App. 34, 408 A.2d 1043 (1979). One prerequisite to setoff is that the Debtor and the bank have mutuality of debts. Mutuality of debts exists when the offsetting claims are due between the same parties acting in the same capacity. *In re Petros Energy & Land Corp.*, 54 B.R. 432 (N.D. Okla. 1985). A bankruptcy filing serves to accelerate the maturity of all debts so that a setoff right may be exercised post-petition. *In re Bass Mechanical Contractors, Inc.*, 84 B.R. 1009 (W.D. Ark. 1988).

The Bankruptcy Code ("Code") specifically preserves a creditor's right of setoff. *See* 11 U.S.C. §553 ("§553"). Subsection (a) of the §553 provides, with exceptions not relevant here, that the Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . ." Further, the legislative history to §553 states that it "preserves, with some changes, the right of setoff in bankruptcy cases now found in §68 of the Bankruptcy Act." *In re Zinke*, 97 B.R. 155 (E.D. N.Y. 1989) (*quoting* H.R. Rep. No. 595, 95th Cong., 1st Sess. 377 (1977), *reprinted in 1978 U.S. Code Cong. & Admin. News* 5963, 6333).[1]

Courts considering the question have consistently recognized a creditor's right to set-off in bankruptcy. *See e.g., In re Applied Logic Corp.*, 576 F.2d 952, 957 (2d. Cir. 1978); *In re Tileston Roberts Corp.*, 75 B.R. 76 (S.D.N.Y. 1987); *In re Petrose Energy and Land Corp., supra; In re Bass Mechanical Contractors, Inc., supra; Bridgeport Company, Inc. v. United States Postal Service*, 39 B.R. 118 (E.D. Ark. 1984). In *In re Applied Logic Corp., supra,* the Court, while acknowledging that one of the "dominant impulses in bankruptcy is equality among creditors" and that with setoff "the dominate

[1] It is also noteworthy that while it was generally held under the Act that Federal law governed issues arising under §68, when "the situation is one that §68 does not prescribe or regulate, . . . the courts apply the law of a state in connection with matters of substantive law relating to the asserted right of set-off—as for example, the imputation of payments on a plurality of obligations held by a creditor." *In re Zink, supra* (*quoting* 4 J. Moore, Collier on Bankruptcy ¶6806 at 886.1 (14th Ed. 1978) (footnotes omitted)).

impulse . . . its inequality among creditors," held that the right of setoff prevailed. As the Court stated, "[t]he rule allowing setoff, both before and after bankruptcy is not one that courts are free to ignore when they think application would be 'unjust'. It is a rule that has been embodied in every bankruptcy act the nation has ever had, and creditors, particularly banks, have long acted in reliance upon it." *Id.* at 957-58 (footnotes omitted). *See also In re Bohack Corp.*, 599 F.2d 1160, 1164-65 (2d. Cir. 1979) (the right of set-off "has the effect of paying one creditor more than another," but despite this inevitable effect, the doctrine of setoff "has long occupied a favored position in our history of jurisprudence.").

Applying the above law to the present case, it is apparent that the Bank should be permitted to apply the funds held by it in the Debtor's bank account against the mature obligation which the Debtor owes to the Bank under the Note.

CONCLUSION

For the foregoing reasons, the Bank's Motion for Relief From Automatic Stay and to Setoff should be granted.

HARTMAN AND CRAIN

By: /s/ C. Edward Hartman III
C. Edward Hartman III

By: /s/ Matthew A. Egeli
Matthew A. Egeli
2660 Riva Road - Fourth Floor
Annapolis, Maryland 21401-7333

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841-5204 (Balt.)
Attorneys for Citizens Bank of Maryland

[Certificate of Service Omitted in Printing]

APPENDIX F

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

Case No. 914-0389-PM
Chapter 13

Motion No. _____

In re:

DAVID STUMPF

Debtor.

DAVID STRUMPF
8150 Lakecrest Drive, #516
Greenbelt, Maryland 20740

Movant,

v.

CITIZENS BANK OF MARYLAND
Serve: Dan Rhodes
14401 Sweitzer Lane
Laurel, Maryland 20707

Respondent.

MOTION TO HOLD CITIZENS BANK OF MARYLAND IN CONTEMPT AND EXPEDITED REQUEST FOR SHOW CAUSE HEARING

The motion of David Strumpf, debtor herein, will show the court the following:

1. Debtor filed a Chapter 13 Voluntary Petition on January 25, 1991.

2. Debtor's Chapter 13 Plan was confirmed on March 20, 1991.

3. On or about February 25, 1991, Respondent was served with an "Order for Meeting of Creditors, Combined With Notice Thereof and of Automatic Stays" (hereinafter "Order").

4. In violation of the "Order" and 11 U.S.C. §362, Respondent placed an administrative hold on Debtor's checking account on October 2, 1991, as evidenced by the attached letter. This action was taken more than seven (7) months after debtor's Chapter 13 Plan was confirmed.

5. This caused a hardship on Debtor and has made it impossible for him to meet his ongoing obligations and to pay his plan payment.

6. Respondent is attempting to collect an Unsecured Consumer Loan Note (copy attached) and, therefore, better its position in relation to other creditors.

7. Counsel for debtor has spoken by telephone to counsel for Respondent and advised him of the provisions of Section 362.

8. Respondent refuses to withdraw the administrative hold and continues to disregard Section 362 and the "Order" of this Court.

9. If Respondent does not release the administrative hold, Debtor will be unable to comply with the terms of his Chapter 13 Plan.

WHEREFORE, Debtor prays:

1. That the Court issue an Order requiring Respondent to file and serve its answer to these allegations, and show cause, if any there be, why it should not be adjudged in civil contempt for failing and refusing to comply with the "Order" and Section 362.

2. That after appropriate proceedings, Respondent be adjudged in contempt and required to purge itself of such contempt by:

(a) releasing the administrative hold on all accounts of debtor,

(b) paying all costs, expenses and attorney's fees incurred by debtor in connection with this motion, and

(c) paying damages to Movant in an amount set by the Court.

3. That this Court grant such other and further relief as it deems necessary.

/s/ John R. Owen, Jr.
John R. Owen, Jr.
1835 University Blvd., Ste. 232
Hyattsville, Maryland 20783
(301) 445-2100

DECLARATION

I. DAVID STRUMPF, declare and affirm under penalty of perjury that the contents of the foregoing motion are true and correct to the best of my knowledge, information and belief.

/s/ David Strumpf
DAVID STRUMPF

[Reporter's Certificate Omitted In Printing]

HARTMAN AND CRAIN

ATTORNEYS AT LAW
2660 RIVA ROAD - FOURTH FLOOR
ANNAPOLIS, MARYLAND
21401-7333

October 2, 1991

John R. Owen, Jr.
1835 University Boulevard
Suite 232
Hyattsville, Maryland 20783

David Strumpf
8150 Lake Crest Drive, #516
Greenbelt, Maryland 20770

RE: Citizens Bank of Maryland v. David Strumpf
Out File No.: 100.600.280

Dear Messrs. Owen and Strumpf:

This is to notify you that, with the filing of the enclosed Motion for Relief from Automatic Stay and for Setoff, the Bank has placed an administrative hold on your checking account up to $3,500.00 pending the outcome of the Motion.

Should you have any questions, please feel free to call.

Sincerely,

/s/ Matthew A. Egeli
Matthew A. Egeli

MAE/pa

APPENDIX G

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND
AT ROCKVILLE

[Caption Omitted In Printing]

ORDER FINDING RESPONDENT IN CONTEMPT
AND AWARDING SANCTIONS

This matter is before the court upon the motion of the debtor to hold Citizens Bank of Maryland in contempt, the response of Citizens Bank, respondent, and after a hearing thereon and the count having considered the memoranda of the parties and the arguments in open court, and the court having stated its findings of fact and conclusions of law on the record at the conclusion of the hearing, and the court finding that the action of the said respondent in placing an administrative hold on the checking account of the debtor was a violation of the automatic stay of 11 U.S.C. §362(a), thereby entitling debtor to damages under 11 U.S.C. §362(h), it is, this 20th day of November, 1991, by the United States Bankruptcy Court for the District of Maryland,

ORDERED That the debtor is allowed counsel fees for the prosecution of the contempt action in the sum of $500.00; and it is further

ORDERED That the debtor is allowed punitive damages in the sum of $375.00 against the respondent; and it is further

ORDERED That debtor is allowed nominal damages in the sum of $25.00; and it is further

ORDERED That payment of all of the foregoing is to be made by respondent to the debtor, in care of his

counsel of record, on or before the 11th day of December, 1991.

/s/ Paul Mannes
PAUL MANNES, Chief Judge
United States Bankruptcy Court
for the District of Maryland

ENTERED: November 21, 1991

cc: John R. Owen, Jr.
C. Edward Hartman III
David Strumpf
Thomas Lackey

APPENDIX H

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND

[Caption Omitted In Printing]

Motion No.: 91M-2236-PM

ORDER GRANTING RELIEF FROM AUTOMATIC STAY AND AUTHORIZING SETOFF

Having read and considered the Motion for Relief from Automatic Stay and to Setoff of Citizens Bank of Maryland, a Creditor, and all other matters in this case, it is this 25th day of November, 1991, by the United States Bankruptcy Court for the District of Maryland

ORDERED, that Citizens Bank of Maryland be and hereby is granted relief from the automatic stay; and it is further

ORDERED that Citizens Bank of Maryland be and hereby is authorized to setoff the funds in the checking account number 04261382 in the amount of Two Thousand Eight Hundred Seventy-Seven and 10/100 Dollars ($2,877.10) plus additional interest at the rate of $1.15 per diem from October 15, 1991 through the date of this Order, and attorney's fees of Three Hundred Eighty-Two and 58/100 Dollars ($382.58).

/s/ Paul Mannes
JUDGE

cc: C. Edward Hartman III, Esquire
Hartman and Crain
2660 Riva Road - Fourth Floor
Annapolis, Maryland 21401-7333

John R. Owen, Jr., Esquire
1835 University Boulevard, Suite 232
Hyattsville, Maryland 20783

David Strumpf
4620 North Park Avenue, #1410E
Chevy Chase, Maryland 20815.

Thomas Lackey, Trustee

Entered: December 2, 1991

APPENDIX I

CITIZENS BANK OF MARYLAND, Appellant

v.

DAVID STRUMPF, Appellee

Civil No. HAR-91-3692

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

138 B.R. 792

March 27, 1992, Decided
March 30, 1992, Filed

COUNSEL: Attorney for Appellant, C. Edward Hartman, III, Annapolis, MD 21401.

Attorney for Appellee, John R. Owen, Jr., Hyattsville, MD 20782.

JUDGES: Hargrove

MEMORANDUM OPINION

Currently before this Court is Citizens Bank of Maryalnd's ("Citizen's Bank") appeal from the United States Bankruptcy Court for the District of Maryland. The issues have been fully briefed, and no hearing is deemed necessary.

The first issue presented to this Court is whether the Bankruptcy Court erred as a matter of law in holding that the Appellant violated the automatic stay of 11 U.S.C. §362(a) when it placed an administrative hold on the Appellee's checking account pending the Bankruptcy Court's disposition of the Appellant's Motion for Relief from Automatic Stay and for Setoff. The second issue before this Court is whether the Bankruptcy Court erred

in finding the Appellant in contempt and assessing attorney's fees, punitive damages, and nominal damages under 11 U.S.C. §362(h).

FACTS

Citizens Bank loaned Strumpf $5,068.75 pursuant to an unsecured consumer loan note ("Note") on November 28, 1989. Strumpf agreed to pay off the loan (including interest) in twenty-four monthly installments. The Note provided for the immediate acceleration of the amount due upon default, and for the payment of attorney's fees upon referral of the matter to an attorney for collection. The note further provided for the right of setoff.

On January 25, 1991, Strumpf filed a Petition for Relief under Chapter 13 of Title 11, U.S.C., in the Bankruptcy Court. (Case No. 91-40389PM). At the time of the filing of the Petition, Strumpf had a checking account with Citizens Bank, containing $11,279.86. Because Strumpf had failed to make scheduled payments, Citizens Bank declared the Note in default.

On October 7, 1991, Citizens Bank filed a Motion for Relief from Automatic Stay and for Setoff against Strumpf. In the Motion, Citizens Bank sought permission to setoff the amounts owed on the Note against the amounts then in Strumpf's checking account. Simultaneous with filing the Motion for Relief from Automatic Stay and for Setoff, Citizens Bank placed an administrative hold on $3,500 in Strumpf's checking account,[1] pending a ruling by the Bankruptcy Court on the Motion. Citizens Bank took this action to prevent Strumpf from

[1]The amount due on the Note as of that date, including attorney's fees, was $3,250.48.

removing funds to which Citizens Bank claimed a setoff right.

On October 9, 1991, Strumpf filed a Motion to hold Citizens Bank in contempt for violation of the automatic stay of 11 U.S.C. §362(a), when it placed the administrative hold on the checking account. On November 4, 1991, the Bankruptcy Court, Judge Paul Mannes presiding, held a hearing on Citizens Bank's Motion for Relief from Automatic Stay and for Setoff, and reserved ruling on the Motion. On November 13, 1991, Judge Mannes held a hearing on Strumpf's Contempt Motion, granted the Motion, and ordered Citizens Bank to pay counsel fees of $500.00, punitive damages of $375.00, and nominal damages of $25.00. This ruling was set forth in a written Order on November 21, 1991.

Later, in a written Order entered December 2, 1991, Judge Mannes granted Citizens Bank's Motion for Relief from Automatic Stay and Setoff. Citizens Bank, in compliance with Judge Mannes contempt ruling, had lifted the administrative hold on the checking account. Before the granting of Citizens Bank's Motion for Relief from Automatic Stay and Setoff, Strumpf had removed all funds from the checking account.

I.

Citizens Bank cites a substantial body of persuasive caselaw for the proposition that a bank's placing of an administrative hold on a debtor's account pending the disposition of a motion asserting the bank's right of setoff is not a violation of the automatic stay. *See, e.g., Bank of America Nat'l Trust & Sav. Ass'n v. Edgins*, 36 B.R. 480 (9th Cir. Bankr. App. 1984); *Rio v. Army Aviation Center Fed. Credit Union*, 82 B.R. 138 (M.D.

Ala. 1986); *Stann v. Mid. Am. Credit Union*, 39 B.R. 246 (D. Kan. 1984); *In re Archer*, 34 B.R. 28 (B.C. N.D. Tex. 1983); *In re Bass Mechanical Contractors, Inc.*, 84 B.R. 1009 (Bankr. W.D. Ark. 1988); *Kenney's Franchise Corp. v. Cent. Fidelity Bank, NA*, 22 B.R. 747 (W.D. Va. 1982); *In re Williams*, 61 B.R. 567 (Bankr. N.D. Tex. 1986); *In re Hoffman*, 51 B.R. 42 (Bankr. W.D. Ark. 1985); *In re Gazelle, Inc.*, 17 B.R. 617 (Bankr. W.D. Wis. 1982); and *In re Carpenter*, 14 B.R. 405 (Bankr. M.D. Tenn. 1981).

The notion of the "banker's dilemma" supports the argument that banks have a right to place an administrative hold on a debtor's account pending further disposition of the funds:

> [W]hen a bankruptcy is filed, a bank claiming a right of set-off in a debtor's account may be faced with a dilemma–whether it should turn over proceeds of [the] debtor's account or whether it should exercise its set-off rights in violation of the automatic stay. To avoid this dilemma, many courts have allowed banks to place an "administrative freeze" on a debtor's account pending further disposition of the funds without violating the automatice stay. The placing of an administrative freeze on a debtor's account offers a way to preserve the debtor's account and is not a direct or indirect attempt to improve the bank's right to a distribution of assets.

Citizens Bank found itself in precisely this banker's dilemma until it placed an administrative hold on the debtor's account. Citizens Bank was not exercising its right of setoff without obtaining prior relief from the automatic stay–rather, it was acting to preserve the debtor's account until the Bankruptcy Court ruled on the Motion for Relief from Automatic Stay.

The Bankruptcy Court relief on the cases of *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), and *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), in holding that Citizens Bank's placing of an administrative hold on Strumpf's checking account was a violation of the automatic stay. Citizens Bank argues, however, that both *Reynolds* and *Norton*, are distinguishable from the case at bar. First, in those cases the Courts held that the United States, as a creditor, was not entitled to setoff income tax deficiencies which were scheduled to be paid in the debtors' confirmed Chapter 13 reorganization plans. In the case at bar, no provision was made in Strumpf's Chapter 13 plan to pay Citizens Bank's claim as a secured creditor. As such, the reorganization plan did not provide "adequate protection" for the Bank's security interest.

More importantly, in both *Reynolds* and *Norton*, the United States intended to hold the frozen funds until the Chapter 13 cases were closed. As such, the Courts viewed the retention of funds by the IRS as the equivalent of a setoff. In the case at bar, by contrast, the administrative hold was merely designed to hold the funds until the Bankruptcy Court ruled on the disposition of the funds. Had Citizens Bank sought to retain the funds without court approval until the entire Bankruptcy proceeding was closed, it would appear that the Bank was using the funds as a setoff, in violation of the automatic stay. However, Citizens Bank, upon finding itself in the banker's dilemma, acted reasonably by simply freezing the checking account funds only until the Bankruptcy Court ruled on its Motion for Relief from Automatic Stay and for Setoff.[2]

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[2]The Court in *Reynolds* addresses the concern that by unilaterally freezing funds, "the funds would become unavailable for

[footnote continued]

Further, it is noteworthy that in the case of *Craddock-Terry Shoe Corp. v. Crestar Bank*, 91 B.R. 392 (Bankr. W.D. Va. 1988), a case from the same district as *Reynolds*, the Court held, relying on *Kenney's Franchise Corp. v. Cent. Fidelity Bank*, 22 B.R. 747 (W.D. Va. 1982), that a bank's action in placing an administrative freeze on a debtor's account pending the resolution of its right of setoff was not a violation of the automatic stay.

Citizens Bank argues that it was relying on the substantial body of caselaw supporting its right to place an administrative hold on Strumpf's checking account pending the Bankruptcy Court's resolution of the Motion for Relief from Automatic Stay and for Setoff. In ruling that the administrative hold violated the automatic stay, the Bankruptcy Court effectively extinguished the Bank's right to setoff because, by the time the Motion for Relief from Automatic Stay and for Setoff was ruled upon, the Bank no longer possessed any of Strumpf's money. Citizens Bank asserts that the Bankruptcy Court's ruling effectively rendered the common law right of setoff unenforceable.

The Bankruptcy Court ruled on the Contempt Motion prior to ruling on the Motion for Relief from Automatic

---

distribution to other creditors or for use by the debtor in a Chapter 13 plan, thus making it much less likely that the debtor could be rehabilitated." *Id.* at 1007. The Court notes that this problem would occur if the bank were using the money in the account for setoff without the authority of the Bankruptcy Court. In the case at bar, however, the Bank was merely awaiting instructions from the Bankruptcy Court, and obviously needed to freeze the funds such that the ultimate ruling of the Bankruptcy Court on the Bank's Motion could be carried out. As soon as the Bankruptcy Court ruled on the Bank's Motion, the Bank could have either lifted the freeze or exercised its setoff rights, as directed by the Bankruptcy Court.

Stay and for Setoff. The ironic result for Citizens Bank was that it was held in Contempt, was later granted its Motion for Relief from Automatic Stay and for Setoff, but could not exercise its right to setoff because (as predicted by Citizens Bank) Strumpf had removed the money from the checking account. This series of events rendered the Bankruptcy Court's ultimate granting of Citizens Bank's Motion meaningless.

The Court finds that the placing of an administrative hold on an account pending the Bankruptcy Court's ruling on the Bank's Motion for Relief from Automatic Stay and for Setoff does not equate to a setoff as a matter of law. In fact, permitting the Bank to freeze the funds until such time as the Court rules on the Bank's Motion for Relief from Automatic Stay and for Setoff is the only sensible procedural approach under these circumstances.

II.

Given the existing law supporting the Bank's right to freeze the account, and given the "catch-22" nature of the circumstances for the Bank in this case, it would be patently unfair to uphold the Bankruptcy Court's finding of contempt. Citizens Bank has noted that the issue of whether a bank may impose an administrative hold on a debtor's checking account has not been addressed by this Court in a published decision, and that any ambiguity in the law should be resolved in favor of the party charged with contempt. *Int'l Brotherhood of Teamsters, etc. v. W. Pa. Motor Carriers Ass'n*, 660 F.2d 76, 82 (3rd Cir. 1981). In any event, the Court agrees with Citizens Bank's interpretation of the applicable law, and as such, the Bankruptcy Court's finding of contempt cannot be upheld. Accordingly, the Bankruptcy

Court's finding of contempt and assessment of attorney's fees, punitive damages, and nominal damages against Citizens Bank under 11 U.S.C. §362(h) must be reversed. It will be so ordered.

3/27/92 Date

John R. Hargrove
United States District Judge

ORDER

In accordance with the foregoing Memorandum Opinion, IT IS, this 27th day of March, 1992, by the United States District Court for the District of Maryland, hereby ORDERED:

1. That the November 20, 1991 Order of the Bankruptcy Court for the District of Maryland, finding Appellant in Contempt for a violation of the automatic stay of 11 U.S.C. §362(a), and awarding sanctions under 11 U.S.C. §362(h), BE and the same hereby IS REVERSED.

2. That the Clerk of the Court CLOSE this case;

3. That the Clerk of the Court mail copies of this Order and the accompanying Memorandum Opinion to the Honorable Paul Mannes and all parties of record.

John R. Hargrove
United States District Judge

APPENDIX J

In re: DAVID STRUMPF, Debtor.

CITIZENS BANK OF MARYLAND,
Plaintiff-Appellee,

v.

DAVID STRUMPF, Defendant-Appellant.

No. 92-1519

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

37 F.2d 155

February 2, 1993, Argued
October 13, 1994, Decided

COUNSEL: Argued: John Randall Owen, Jr., JOHN R. OWEN, JR. & ASSOCIATES, P.C., Hyattsville, Maryland, for Appellant.

Argued: Matthew A. Egeli, HARTMAN & CRAIN, Annapolis, Maryland, for Appellee.

On Brief: C. Edward Hartman, III, HARTMAN & CRAIN, Annapolis, Maryland, for Appellee.

JUDGES: Before RUSSELL and WIDENER, Circuit Judges, and CHAPMAN, Senior Circuit Judge. Judge Widener wrote the opinion, in which Judge Russell and Senior Judge Chapman concur.

WIDENER, Circuit Judge:

This case presents an issue of first impression on the same facts in the courts of appeal, although the Third and Eighth Circuits have considered similar fact situations, as have we. It is whether a bank violates the automatic

stay of 11 U.S.C. §362(a) by placing an administrative hold on a debtor's account while seeking relief from the stay to exercise its right of setoff. The United States Bankruptcy Court for the District of Maryland held Citizens Bank of Maryland (Citizens) in contempt for violating the automatic stay and awarded damages to Strumpf under 11 U.S.C. §362(h). See *Citizens of Md. v. Strumpf*, 138 B.R. 792 (D. Md. 1992). On appeal, the United States District Court for the District of Maryland reversed. See 138 B.R. at 795. Strumpf now appeals and we reverse.

I.

On November 28, 1989, Citizens loaned Strumpf $5,068.75 on a note as an unsecured consumer loan to be repaid in 24 monthly installments. See 138 B.R. at 792. Upon default, the note provided Citizens with the right to immediately accelerate the amount due, the right to recover attorney's fees incurred in collection, and the right of setoff. See 138 B.R. at 792. On January 25, 1991, Strumpf filed a Chapter 13 bankruptcy petition. See 138 B.R. at 792. At the time of filing, Strumpf had $11,279.86 in a checking account with Citizens, and the note was in default because Strumpf had failed to make scheduled payments. See 138 B.R. at 792. On March 20, 1991, the bankruptcy court confirmed Strumpf's repayment plan.

On October 7, 1991, Citizens filed a motion for relief from the automatic stay and for setoff and placed an administrative hold on $3,500 in Strumpf's checking account, $3,250.48 being due on the note at the time. See 138 B.R. at 792-93. On October 9, 1991, Strumpf filed a motion to hold Citizens in contempt for violating the automatic stay of §362(a). See 138 B.R. at

793. The bankruptcy court reserved ruling on Citizens' motion on November 4, 1991, and then granted Strumpf's motion on November 13, awarding him attorney's fees of $500, punitive damages of $375, and nominal damages of $25. See 138 B.R. at 793. On December 2, the bankruptcy court granted Citizens' motion for relief from the stay and authorized it to exercise its right of setoff. See 138 B.R. at 793. Citizens, however, was unable to set off its loan because Strumpf had withdrawn all funds from his checking account after Citizens removed the administrative hold. See 138 B.R. at 793.

II.

The right of setoff may arise contractually or under state law, see 4 *Collier on Bankruptcy* ¶553.06 (15th ed. 1992), and it allows a creditor to apply one mutual debt against another to avoid "the absurdity of making A pay B when B owes A." *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528, 33 S. Ct. 806, 808, 57 L.Ed. 1313 (1913). While the Bankruptcy Code preserves a creditor's right of setoff that arose before the filing of a petition in bankruptcy, see 11 U.S.C. §553(a), the Code stays the exercise of the right of setoff by making it subject to the automatic stay of §362(a).* See 11 U.S.C. §362(a)(7). To exercise its right of setoff, a creditor must obtain relief from the automatic stay by filing a motion with the bankruptcy court. See 11 U.S.C. §362

*The Code also grants creditors with a valid right of setoff two other rights. Section 506(a) gives a creditor a secured claim to the extent of the amount subject to setoff. See 11 U.S.C. §506(a). Section 542(b) excepts a creditor from turning over property to the debtor's estate to the extent of the setoff. See 11 U.S.C. §542(b).

(d). If the creditor fears that the property subject to the motion will suffer irreparable damage before notice and hearing may be had, the creditor may even file an ex parte motion under §362(f). See 11 U.S.C. §362(f). Any relief from the automatic stay rests within the sound discretion of the bankruptcy court. See *Small Business Admin. v. Rinehart*, 887 F.2d 165, 169 (8th Cir. 1989).

If the debtor learns of the motion for relief from the stay, however, the debtor may defeat the creditor's right of setoff by removing all funds in the creditor's possession before the creditor can obtain relief from the stay. Therefore, even if the creditor is granted relief from the automatic stay, the creditor will have nothing with which to set off the debt owing it. As the district court recognized, this scenario is known as the "banker's dilemma": "[W]hen a bankruptcy is filed, a bank claiming a right of set-off in a debtor's account may be faced with a dilemma—whether it should turn over proceeds of [the] debtor's account or whether it should exercise its set-off rights in violation of the automatic stay." *Citizens Bank*, 138 B.R. at 702, quoting from *In re Bass Mechanical Contractors, Inc.*, 84 B.R. 1009, 1022 (Bankr. W.D. Ark. 1988). Recognizing this dilemma, some bankruptcy and district courts have held that pending a motion for relief from the stay, a creditor asserting a right of setoff may place an administrative hold on a debtor's account without violating the automatic stay of §362(a). See *Citizens Bank*, 138 B.R. at 793 (holding same and collecting cases). Relying on this body of case law, Citizens placed an administrative hold on Strumpf's account and filed a motion for relief from the stay. See 138 B.R. at 794.

While we understand the dilemma that Citizens and other similarly situated creditors face, we cannot overlook the fact that the Code does not authorize such action, and is quite to the contrary. Setoff is explicitly within the terms of section 362(a)(7) which stays a creditor from exercising its right of setoff unless and until the creditor obtains relief from the stay. In *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), we held that a freeze by the Internal Revenue Service (IRS) on a debtor's tax refund "was a setoff subject to the automatic stay and that the IRS violated the stay in retaining the funds." 764 F.2d at 1006-07. Based on this holding, we are of opinion that an administrative hold is tantamount to the exercise of a right of setoff and thus violates the automatic stay of §362(a)(7). See 764 F.2d at 1006-07. As well as *Rinehart, supra, United States v. Norton*, 717 F.2d 767, 773 (3d. Cir. 1983) and *In Re Penn Central Transportation Company*, 453 F.2d 520 (3d. Cir. 1972) (a railway reorganization under the Bankruptcy Act) are on slightly different facts but are fully in accord with our decision. Whether the creditor actually offsets the debtor's account or places a hold on the debtor's account, both effectively deprive the debtor of the use of the funds pending the outcome of the motion for relief from the stay. See *Rinehart*, 887 F.2d at 168.

Citizens attacks this holding, the same one reached by the bankruptcy court, claiming that *Reynolds* is distinguishable and that equating an administrative hold with the exercise of the right of setoff renders the right of setoff unenforceable and effectively repeals §553(a). Citizens states that unlike the IRS in *Reynolds*, Strumpf's plan made no provision to pay Citizens as a secured creditor despite its status as a secured creditor under §506(a). Furthermore, Citizens claims that, unlike the IRS, it did not intend to keep the hold on Strumpf's account until the end of his Chapter 13 plan.

We are not persuaded by Citizens' efforts to distinguish *Reynolds*. While the fact that Citizens was not provided for as a secured creditor in Strumpf's plan might be taken into account in deciding whether the bankruptcy court should grant Citizens relief from the automatic stay under §362(d)(1), it has no bearing on whether Citizens acted properly in placing an administrative hold on Strumpf's account. We are further of opinion that the length of time a creditor intends to maintain a hold is not relevant to whether a hold is tantamount to a setoff. In *Reynolds* the IRS intended to hold the funds until the Chapter 13 plan was closed because the bankruptcy court had denied it relief from stay due to its status as a secured creditor with adequate protection. See 764 F.2d at 1007. In this case, Citizens intended to hold Strumpf's account only until it could get relief from stay. These cases indicate to us that the length of time a creditor intends to maintain the hold is determined by that same creditor's ability to get relief from the automatic stay and exercise its right of setoff, so the length of time is not relevant to whether a hold is tantamount to a setoff.

We likewise are not persuaded by Citizens' claims that our holding renders the right of setoff unenforceable and effectively repeals §553(a). Statutory construction begins with the literal language of a statute, see *United States v. Turkette*, 452 U.S. 576, 580, 101 S. Ct. 2524, 2527, 69 L.Ed.2d 246 (1981), and if the language is clear and unambiguous our task is at an end unless a literal reading of the statute contravenes the clearly expressed legislative intent of Congress. See *Russello v. United States*, 464 U.S. 16, 20, 104 S. Ct. 296, 299, 78 L.Ed. 2d 17 (1983). While the banker's dilemma may allow a debtor to defeat a creditor's right of setoff, the clear and

unambiguous language of §362(a) produces this result. Furthermore, our holding does not contravene any clearly expressed legislative intent of Congress:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

House Report No. 95-585, 95th Cong., 1st Sess. 340-2 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 54-55 (1978); *reprinted in* 1978 U.S.C.C.A.N. 5787 at 5840 and 6296-7. "If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished." See *Reynolds*, 764 F.2d at 1007 (quoting *Norton*, 717 F.2d at 773).

III.

As for the bankruptcy court's award of attorney's fees, punitive damages and nominal damages, we are of opinion that such an award was appropriate and not an abuse of discretion. See *Budget Service Co. v. Better Homes of Va.*, 804 F.2d 289, 292-93 (4th Cir. 1986). To award damages under §362(h) the bankruptcy court need only find a willful violation of the automatic stay of §362(a). To constitute a willful act, the creditor need not act with specific intent but must only commit an intentional act with knowledge of the automatic stay. See *Budget Service*, 804 F.2d at 292-293; *In Re Atl. Business & Community Corp.*, 901 F.2d 325, 329 (3d Cir. 1990). In this case there is no doubt that Citizens

had knowledge of the stay when it placed the hold on Strumpf's account because the placing of the hold was an attempt to buy time while seeking relief from the automatic stay.

IV.

We are thus of opinion that Citizens' administrative hold on Strumpf's account violated the automatic stay provisions of §362(a)(7) and that the bankruptcy court did not abuse its discretion by finding Citizens had violated the automatic stay and awarding damages.

Accordingly, we reverse the decision of the district court and remand with instructions to reinstate all of the decision of the bankruptcy court except that part which may have held Citizens in contempt of court. That part of the decision of the district court with reference to holding Citizens in contempt of court is not appealed by Strumpf (Brief, p. 7-8), although that part finding Citizens had not violated §362(a)(7) and not awarding damages under §362(h) was appealed. In all events, the finding of contempt was surplusage. See *Budget Service Company*, 804 F.2d 289, 293, and no.4.

REVERSED AND REMANDED WITH INSTRUCTIONS.

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No. 94-1340

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff right, without violating the bankruptcy stay under 11 U.S.C. §362(a).

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No. 94-1340

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ON WRIT OF CERTIORARI TO
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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at 37 F.3d 155 (4th Cir. 1994). (J.A. 39a). The opinion of the United States District Court for the District of Maryland is reported at 138 B.R. 792 (D. Md. 1992). (J.A. 31a). The ruling of the United States Bankruptcy Court for the District of Maryland is not reported. (J.A. 27a, 29a).

JURISDICTION

The United States Court of Appeals for the Fourth Circuit entered its judgment on October 13, 1994. The court of appeals entered an order denying Citizens Bank of Maryland's motion for rehearing, or in the alternative, suggestion of rehearing in banc on November 8, 1994. Citizens Bank of Maryland's petition for a writ of certiorari was filed in this Court on February 6, 1995, and was granted on March 27, 1995. This Court has jurisdiction under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves consideration of five sections of the United States Bankruptcy Code, 11 U.S.C. §§101, *et seq.* (1988).[1] They are 11 U.S.C. §§362, 363, 506(a), 542(b) and 553. The pertinent text of each of these sections is set forth in the Appendix found at the end of this Brief. Because this case was commenced prior to the Bankruptcy Reform Act of 1994, enacted on October 22, 1994, the provisions of the Code referred to in this Brief are those in effect prior to the 1994 amendments. None of these provisions, however, has been amended by the Bankruptcy Reform Act of 1994 in a manner material to the outcome of this case.

This case also raises a question under the Fifth Amendment to the United States Constitution, which provides: "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any

[1]The United States Bankruptcy Code is hereinafter sometimes referred to as the "Bankruptcy Code" or the "Code."

person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V.

STATEMENT OF THE CASE

On November 28, 1989, the Petitioner, Citizens Bank of Maryland ("Citizens"),[2] loaned the Respondent, David Strumpf ("Strumpf" or the "Debtor"), $5,068.75. The loan was evidenced by an unsecured consumer loan note ("the Note"), (R. 1) (the Note),[3] in which Strumpf agreed to repay the loan (including interest) in twenty-four monthly installments. The Note provided for the immediate acceleration of the amount due upon default, the payment of attorney's fees, and expressly granted Citizens the right of setoff upon default. *Id.*

On January 25, 1991, Strumpf filed a petition for relief under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Maryland. (J.A. 3a); (R. 1) (Chapter 13 plan, statement,

[2]Pursuant to Supreme Court Rule 29.1, Citizens discloses that Citizens Bank of Maryland is a wholly owned subsidiary of Citizens Bancorp, a bank holding company chartered under the laws of the state of Maryland, the stock of which is publicly traded. Citizens Bank of Maryland has no subsidiaries, other than wholly owned subsidiaries.

[3]As the pages of the certified record are not consecutively paginated, citations to the record are to the docket entry in the record, followed by a parenthetical describing the specific document within the docket entry to which citation is made. For example, in this citation, the Note may be found at docket entry number 1 (which is the entire bankruptcy court record as submitted to the district court) of the certified record.

and statement of affairs with voluntary petition). At the time of the filing of his bankruptcy petition, Strumpf had a checking account with Citizens containing a balance of $11,279.86, and the Note was in default. (J.A. 18a-19a).

On or about February 26, 1991, the bankruptcy court issued to Strumpf's creditors a copy of an Order for Meeting of Creditors, Combined with Notice Thereof and of Automatic Stays, informing them of Strumpf's bankruptcy filing and other important dates for the case. Included among these dates was June 13, 1991, the date by which creditors had to file a proof of claim in order to have a claim allowed and to share in distributions from the estate. (J.A. 5a). In accordance with that order, Citizens timely filed its proof of claim on June 13, 1991, asserting a secured claim in the amount of $2,555.50. On April 8, 1991, the bankruptcy court entered an order confirming Strumpf's Chapter 13 plan. (J.A. 10a). The plan made no mention of Citizens or its particular claim.

On October 7, 1991, Citizens filed in the bankruptcy court a Motion for Relief from Automatic Stay and for Setoff, asking the bankruptcy court for permission to exercise its right to set off Strumpf's debt to Citizens under the Note against funds held on deposit in Strumpf's checking account at Citizens. (J.A. 15a). As stated in Citizens' motion, the amount then due on the Note, including attorney's fees, was $3,259.68. Contemporaneously with the filing of the motion, Citizens placed an administrative "hold" on $3,500.00 in Strumpf's checking account, the balance of which was then $7,206.59. (J.A. 26a). The administrative hold allowed Strumpf to withdraw from his account all but $3,500.00, thus preventing Strumpf from withdrawing funds to which Citizens claimed a setoff right.

On October 9, 1991, Strumpf filed a motion to hold Citizens in contempt, claiming that the administrative hold on his bank account violated the automatic stay of 11 U.S.C. §362(a). (J.A. 23a). The Debtor also filed on October 31, 1991, a second motion against Citizens, requesting that Citizens be ordered to release the administrative hold and turn over all funds in the account to Strumpf. (R. 1) (Strumpf's motion seeking release of administrative hold and turnover of funds). On November 4, 1991, the bankruptcy court (the Honorable Paul Mannes, Chief Judge, presiding), held a hearing on Citizens' motion for relief from automatic stay and for setoff, at the conclusion of which the court requested Strumpf's counsel to submit a legal memorandum and reserved ruling on the merits. (R. 1) (transcript of Nov. 4, 1991 hearing). On November 13, 1991, Judge Mannes held a hearing on Strumpf's motion to hold Citizens in contempt, and granted the motion, holding Citizens in contempt for violating the automatic stay and awarding Strumpf attorney's fees of $500.00, punitive damages of $375.00, and nominal damages of $25.00. (J.A. 27a).

In reaching this result, the court clearly felt bound by the decision of the Fourth Circuit in *United States v. Reynolds,*[4] stating that under *Reynolds*, "I have to find that Citizens Bank violated the stay of 11 U.S.C. §362(a)(7) through the administrative freeze process used here." (R. 1) (transcript of Nov. 13, 1991 hearing). Judge Mannes indicated that his own view of the correct result may have been different: "Were the decision on my part one written on a clean slate, I might look at the case somewhat differently." *Id.*

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[4] 764 F.2d 1001 (4th Cir. 1985). *See infra* at 36-38 for a discussion of the *Reynolds* case.

On December 2, 1991, the bankruptcy court granted Citizens' motion for relief from the automatic stay, authorizing Citizens to exercise its right of setoff against the funds in Strumpf's account. (J.A. 29a). By that time, however, Citizens was unable to effectuate a setoff because Strumpf had withdrawn all of the funds from his account after Citizens lifted the administrative hold as required by the bankruptcy court's earlier contempt order.

Citizens appealed the bankruptcy court's decision on Strumpf's contempt motion to the United States District Court for the District of Maryland (the Honorable John R. Hargrove, presiding). (R. 1) (notice of appeal). Strumpf did not appeal from the bankruptcy court's order granting Citizens relief from the automatic stay. The district court reversed the decision of the bankruptcy court, summing up the proceedings below:

> The ironic result for Citizens Bank was that it was held in contempt, was later granted its Motion for Relief From Automatic Stay and for Setoff, but could not exercise its right to setoff because (as predicted by Citizens Bank) Strumpf had removed the money from the checking account. This series of events rendered the Bankruptcy Court's ultimate granting of Citizens Bank's Motion meaningless.

(J.A. 31a, 37a); *Citizens Bank of Maryland v. Strumpf*, 138 B.R. 792, 794 (D. Md. 1992), *rev'd*, 37 F.3d 155 (4th Cir. 1994). The district court held that the placement of an administrative hold on funds in an account pending the bankruptcy court's ruling on a motion for relief from stay did not equate to a setoff and did not violate the automatic stay. *Id.* As stated by the district court, "permitting the bank to freeze the funds until such time as the Court rules on the Bank's Motion for

Relief from Automatic Stay and for Setoff is the only sensible procedural approach under these circumstances." *Id.*

Strumpf appealed the district court's judgment to the United States Court of Appeals for the Fourth Circuit, which reversed the district court's ruling and remanded the case for reinstatement of the bankruptcy court's order. (J.A. 39a); *Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155, 159 (4th Cir. 1994). The opinion of the Fourth Circuit followed the earlier decision of a panel of the same court in *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), a case involving a "freeze" of a tax refund by the Internal Revenue Service, and concluded that the administrative hold was "tantamount" to a setoff and violated 11 U.S.C. §362(a)(7). *Strumpf*, 37 F.3d at 158. The court further reasoned that while the "banker's dilemma" created by mutual obligations between a bank and its depositor may allow a debtor to defeat a creditor's right of setoff, the language of §362(a) produces this result. *Id.* at 149. On October 27, 1994, Citizens filed a petition for rehearing or, in the alternative, suggestion of rehearing in banc with the Fourth Circuit. On November 8, 1994, this petition was denied.

On February 6, 1995, Citizens filed a petition for a writ of certiorari with this Court, seeking reversal of the Fourth Circuit's decision, and citing to conflict among the lower courts regarding the propriety of the use of an administrative hold in bankruptcy as a substantive basis for this Court's review of the case. On March 27, 1995, this Court granted Citizens' petition for a writ of certiorari.

SUMMARY OF THE ARGUMENT

The right to setoff mutual debts has long been recognized in American common law, and in bankruptcy law. The doctrine of setoff is premised upon the "absurdity of making A pay B when B owes A," *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913), and recognizes the inherent fairness and efficiency in canceling mutual obligations to arrive at one true debt.

The application of this setoff doctrine in cases under the Bankruptcy Code involving a nonbank creditor is straightforward and has generated little controversy, with the exception of cases involving the Internal Revenue Service ("IRS"). The Bankruptcy Code, in §553, expressly recognizes and preserves a creditor's right of setoff. The automatic stay under §362(a)(7) prevents the creditor from exercising its setoff right without first obtaining the bankruptcy court's permission. However, under §542(b) of the Bankruptcy Code, the creditor is not required to pay its debt to the debtor, to the extent of the creditor's claim against the debtor. The mere refusal by the creditor to pay its debt to the debtor is not considered to constitute a setoff and, therefore, is not considered to be a violation of the automatic stay.

The confusion surrounding setoffs under the Bankruptcy Code primarily has arisen if the creditor is a bank where the debtor maintains a bank account and the bank takes some action after the commencement of the depositor's bankruptcy case to restrict the debtor's ability to use the funds on deposit. A bank creditor generally has a right under nonbankruptcy law to offset a depositor's bank account, that is, deduct from the account and apply the amount of deduction to reduce the balance due on the depositor's defaulted debt to the bank. Upon commencement of a bankruptcy case, the bank will

want to preserve its ability to exercise its setoff right against the debtor's bank account, after being authorized to do so by the bankruptcy court, by ensuring that the account funds are not dissipated. The confusion in these cases arises in part from the lower courts' misapprehension of the nature of the relationship between a bank and its depositor.

This Court has long recognized that a bank account creates the relation of debtor and creditor between the bank and its depositor. The money deposited in legal contemplation is a loan to the bank and becomes part of the general funds of the bank, and the depositor has the right to draw on the account to the extent of the deposit. When the depositor files a bankruptcy petition, §542(b) entitles the bank to refuse to pay its obligation to the debtor from the bank's assets to the extent the bank has a right of setoff. The method used by a bank to refuse to pay its obligation to a debtor with respect to the debtor's bank account is referred to as an administrative "hold" or "freeze."

The issue presented in this case is whether the bank can place an administrative hold on the debtor's bank account to preserve the bank's right of setoff against the account prior to obtaining relief from the automatic stay to exercise its setoff right. During the course of Strumpf's bankruptcy case below, Citizens placed an administrative hold on a portion of Strumpf's account at Citizens and contemporaneously filed a motion requesting the bankruptcy court to modify the automatic stay to permit Citizens to accomplish a setoff.

Consistent with §542(b), the imposition of an administrative hold on Strumpf's bank account was not itself a setoff. To the contrary, by filing a motion requesting the bankruptcy court's authority to exercise its setoff

right contemporaneously with its imposition of the administrative hold, Citizens made clear its intention to delay the actual exercise of its setoff right pending bankruptcy court approval. This limited hold on the account did not accomplish the setoff; the balance of the account was not reduced by the amount of the setoff and Citizens in all respects acted in a manner evidencing that the setoff had not been accomplished.

The Fourth Circuit panel below focused only on §§362(a)(7) and 553 of the Bankruptcy Code, and ignored the impact of §§363, 506(a) and 542(b). That error, coupled with the Fourth Circuit's apparent failure to recognize the nature of a bank account as the bank's debt to the debtor rather than funds owned by the debtor, predictably led the Fourth Circuit to the wrong conclusion.

If a financial institution, or for that matter nonbank creditors, were to be denied the ability to use a temporary hold to preserve the *status quo* pending determination of the parties' respective rights, the creditor's valid setoff right would be nullified by the debtor's ability to withdraw or collect the funds faster than the bankruptcy court could rule on the matter. A ruling by the bankruptcy court recognizing the bank's setoff right after all funds are withdrawn is the proverbial attempt to lock the barn door after the horse has been stolen. That is precisely what happened in this case. By the time the bankruptcy court granted Citizens relief from the automatic stay to exercise its right of setoff, Strumpf had withdrawn all of the funds on deposit at Citizens, leaving Citizens with a hollow right and no remedy.

Consequently, the absurdity long eschewed by the doctrine of setoff became a reality in this case. The Bankruptcy Code neither requires nor supports a nullification of a creditor's right of setoff. Accordingly, Citizens respectfully asks this Court to reverse the decision below and to reinstate the decision of the district court.

ARGUMENT

I.

THE BANKRUPTCY CODE EXPRESSLY RECOGNIZES AND PRESERVES A CREDITOR'S SETOFF RIGHT AGAINST A DEBTOR.

A. Citizens Had a Contractual and Common Law Right to Set Off the Debtor's Bank Deposit Against His Obligation to the Bank Prior to the Commencement of the Bankruptcy Case.

The right to set off mutual debts has long been recognized as a venerable right in American common law. Premised upon the "absurdity of making A pay B when B owes A," *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913), the doctrine of setoff recognizes the inherent fairness and efficiency in canceling mutual obligations to arrive at one true debt. The Fourth Circuit's ruling below effectively eviscerates the ability of financial institutions to exercise this important right within the context of a bankruptcy case.

In Maryland,[5] the right of setoff has been defined as,

> the right which exists between two parties, each of whom, under an independent contract, owes an

[5] Because both the Debtor and Citizens, as well as the bank account at issue, are in Maryland, Maryland law determines the state law rights and obligations of the parties. In the absence of controlling federal law, Citizens' interest in Strumpf's bank account by virtue of its setoff right is a creature of state law. *See Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has

[footnote continued]

> ascertained amount to the other, to set off their respective debts by way of mutual deduction, so that in any action brought for the larger debt, the residue only after such deduction, shall be recovered.

Ghingher v. Fanseen, 166 Md. 519, 526, 172 A. 75, 78 (1934) (quoting 24 R.C.L. 792). The right of setoff has been recognized in Maryland continuously since 1785. *See generally* William H. Loyd, *The Development of Setoff*, 64 U. Pa. L. Rev. 541 (1916) (exhaustive analysis of the ancient roots of the doctrine of setoff). *See, e.g., Baltimore Ins. Co. v. M'Fadon*, 4 H. & J. 31, 41-45 (Md. 1815) (interpreting right of setoff established in Maryland by Act of 1785, ch. 45, s. 7); *Tyrrell v. Tyrrell*, 54 Md. 167, 169 (1880); *District Agency Co. v. Suburban Delivery Serv., Inc.*, 224 Md. 364, 370, 167 A.2d 874, 877 (1961) (holding Maryland rules of civil procedure regarding counterclaims encompass right of setoff).

Under Maryland law, a bank creditor may offset money in its customer's bank account against a mature obligation of the customer owed to the bank. *See Hayden v. Citizens Nat'l Bank of Baltimore*, 120 Md. 163, 167, 87 A. 672 (1913); *Records v. McKim*, 115 Md. 299, 305, 80 A. 968 (1911); *Mercantile-Safe Deposit and Trust Co. v. Delp and Chapel Concrete Constr. Co.*, 44 Md. App. 34, 44, 408 A.2d 1043, 1049 (1979); *In re Cummins Constr. Corp.*, 72 F. Supp. 409, 413-14 (D. Md.), *aff'd*, 164 F.2d 983 (4th Cir. 1947), *cert. denied*, 333 U.S. 881 (1948). The foundation for a bank's right of setoff is the creditor-debtor relationship between a depositor and his bank that is created when the depositor opens a bank account.

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generally left the determination of property rights in the assets of a bankrupt's estate to state law."); *McKenzie v. Irving Trust Co.*, 323 U.S. 365, 370 (1945).

The money an account holder deposits into his bank account is, in legal contemplation, a loan to the bank, payable upon demand:

> It may be said generally that the relation of a bank and a depositor is that of debtor and creditor; the money deposited is regarded as a loan to the bank by the depositor, with the right of the depositor to draw on it to the extent of the deposit.

Keller v. Fredericktown Sav. Inst., 193 Md. 292, 296, 66 A.2d 924, 925 (1949). *See also Taylor v. Equitable Trust Co.*, 269 Md. 149, 155, 304 A.2d 838, 842 (1973); *Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold*, 90 Md. App. 360, 376, 608 A.2d 1194, 1201 (1992).

From a nonlegal perspective, it is common, but incorrect, for a depositor to think that the funds in his bank account remain the depositor's funds, just as if they were placed in a safe deposit box and held by the bank for safekeeping. The law is to the contrary. Upon deposit of monies into an account, the bank becomes the owner of the funds. The depositor loses the right of immediate possession of the funds but gains a claim against the bank for an amount equal to the balance in the account. As this Court stated in *New York County Nat'l Bank v. Massey*, 192 U.S. 138, 145 (1904),

> [i]t cannot be doubted that, except under special circumstances, or where there is a statute to the contrary, a deposit of money upon general account with a bank creates the relation of debtor and creditor. The money deposited becomes a part of the general fund of the bank, to be dealt with by it as other moneys, to be lent to customers, and parted with at the will of the bank, and the right of the depositor is to have this debt repaid in whole or in part by

> honoring checks drawn against the deposits. It creates an ordinary debt, not a privilege or right of a fiduciary character.

Accord Bank of Marin v. England, 385 U.S. 99, 101 (1966); *Barnhill v. Johnson*, 503 U.S. 393, 112 S. Ct. 1386, 1389 (1992). Where the depositor is also obligated to the bank for a loan or other similar debt, the depositor and the bank have mutual obligations. The bank owes the depositor an amount equal to the balance of the account, and the depositor owes the bank the amount of his separate obligation.

It is undisputed in the present case that Citizens had a right to set off the amount due under the Note against a portion of the funds in Strumpf's account.[6] *See Mercantile*, 44 Md. App. at 44, 408 A.2d at 1049. Additionally, Citizens possessed the right of setoff against Strumpf's account by contract, pursuant to the express terms of the Note. (R. 1) (the Note).

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[6] By granting Citizens' motion for relief from the automatic stay, thereby expressly authorizing Citizens to exercise its right of setoff, the bankruptcy court concluded that Citizens had a valid right of setoff. (J.A. 29a). This ruling was not appealed by Strumpf and any issue relating to whether a valid right of setoff existed was not raised below.

B. Citizens' Setoff Right is Recognized and Preserved by the Bankruptcy Code.

1. Section 553(a) Expressly Provides that a Creditor's Right to Offset a Mutual Debt is Not Affected by the Bankruptcy Code, Except as Otherwise Provided in Sections 362 and 363.

A resolution of the question presented by this case requires the interpretation of several sections of the Bankruptcy Code. The starting point in construing any statute is the plain language of the statute. *Pennsylvania Public Welfare Dept. v. Davenport*, 495 U.S. 552, 557 (1990); *Kelly v. Robinson*, 479 U.S. 36, 43 (1986); *Consumer Product Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). Where the statute's language is unambiguous, "the sole function of the court is to enforce it according to its terms." *Caminetti v. United States*, 242 U.S. 470, 485 (1917). *Accord Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 112 S. Ct. 1146, 1149 (1992). Separate provisions of the same act are to be given a harmonious and comprehensive meaning. *Clark v. Uebersee Finanz-Korporation, A.G.*, 332 U.S. 480, 488 (1947). Where the statutory scheme is coherent and consistent, there is no need to inquire beyond the plain language. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-41 (1989). Adherence to these maxims leads to a result contrary to the one reached by the Fourth Circuit below.

Section 553 of the Bankruptcy Code expressly preserves the common law right of setoff in bankruptcy cases. It provides, in pertinent part:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does

> not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . .

11 U.S.C. §553(a) (1988).

The preservation of the common law setoff right in bankruptcy proceedings has a long history in American bankruptcy law. *See* 4 James W. Moore & Lawrence P. King, *Collier on Bankrupcy*, ¶553.01, at 553-1 to 553-9 (15th ed. 1994) (tracing the history of the preservation of the setoff right in bankruptcy); Carmelita J. Hammon, *Setoff in Bankruptcy: Is the Creditor Preferred or Secured?*, 50 U. Colo. L. Rev. 511 (1979). The Sixth Circuit Court of Appeals succinctly articulated the rationale for the stringent preservation of this favored right: "The principle upon which the rule [of setoff] proceeds is that in case of mutual debts, it is only the balance which is the real and just sum owing by or to the bankrupt." *Prudential Ins. Co. of America v. Nelson*, 101 F.2d 441, 443 (6th Cir.), *cert. denied*, 308 U.S. 583 (1939).

Section 553 continues this tradition under the Bankruptcy Code. It was intended to carry forward the principles governing setoff that had been found in section 68 of the Bankruptcy Act of 1898, as later amended by the Bankruptcy Act of 1938. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 183-86, 377 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6143-47, 6333. By maintaining a creditor's common law right to set off the obligations of its debtor against its own debt to the debtor, §553 recognizes the injustice in permitting a creditor to obtain repayment of only a portion of the debt owed by the

debtor, while at the same time compelling the creditor to pay its full indebtedness to the debtor.

> Absent a setoff, a creditor . . . is in the worst of both worlds: it must pay its debt to the debtor in full, but is only entitled to receive a tiny fraction of the money the debtor owes it. It was to avoid this unfairness to creditors that setoffs were allowed in bankruptcy in the first place.

In re De Laurentiis Entertainment Group, Inc., 963 F.2d 1269, 1277 (9th Cir.), *cert. denied*, ___ U.S. ___, 113 S. Ct. 330 (1992). *See also* 4 *Collier on Bankruptcy*, *supra*, ¶553.01, at 553.11.

The only significant changes made in the Bankruptcy Code relating to the right to set off mutual prebankruptcy obligations are procedural; they do not alter the long-standing goal of preserving the right of setoff throughout the bankruptcy case. These changes are (i) to limit the exercise of the right of setoff by subjecting the right to the broad scope of the automatic stay of §362; and (ii) to permit the trustee or debtor in possession to use property subject to the right of setoff, under the circumstances described in §363. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 183-86, 377 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6143-47, 6333. *See also* 4 *Collier on Bankruptcy*, *supra*, ¶553.01, at 553-6 to 553-9 (discussing changes made by the Code).[7]

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[7] Section 553 also alters the treatment of claims against the debtor acquired from a third party, a situation not presented by the facts here.

2. The Only Bankruptcy Code Provisions Qualifying a Creditor's Exercise of Its Setoff Right–§§362 and 363–Do Not Eliminate the Right of Setoff.

The automatic stay of §362 is one of the fundamental protections afforded debtors by the Bankruptcy Code. It operates to provide the debtor temporary relief from the actions of creditors enumerated in §362(a). Conversely, §362 is also designed to protect creditors by ensuring that creditors with equal rights are treated equally in the repayment of debts.[8] *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 340-2 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6296-97.

Section 362(a)(7) expressly provides that a creditor may not exercise his right of setoff during the pendency of the bankruptcy case without obtaining relief from the automatic stay. It states, in pertinent part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of–
>
> * * * *
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim of the debtor. . . .

11 U.S.C. §362(a)(7) (1988).

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[8]Creditors with different rights and priorities receive different treatment under the Bankruptcy Code, just as they do outside bankruptcy. For example, a secured creditor is treated quite differently from an unsecured creditor, particularly with respect to the secured creditor's collateral. *See, e.g.*, 11 U.S.C. §§1129(b)(2)(A), 1325(a)(5) (1988). While preserving a creditor's right of setoff has the effect of paying one creditor more than the other, bankruptcy laws have provided for just this result. *See Cumberland Glass Mfg. Co. v. DeWitt*, 237 U.S. 447, 455 (1915).

Although a creditor with a common law right of setoff preserved by §553 is stayed from the exercise of that right during the bankruptcy case absent relief from the stay, §506(a) of the Code makes the creditor a secured creditor to the extent of his right:

> (a) An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.

11 U.S.C. §506(a) (1988). *See In re Santoro Excavating, Inc.*, 32 B.R. 947, 950 (Bankr. S.D.N.Y. 1983). By equating setoff with a secured claim, the Bankruptcy Code recognizes that a creditor with a right of setoff is entitled to a preference over other creditors to the extent of the amount of the setoff right. *See id.*

Where the subject of the right of setoff is a bank account, the creditor's rights as a secured creditor are amplified by the special provisions of the Bankruptcy Code concerning "cash collateral." Section 363(a) defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest . . . ." 11 U.S.C. §363(a) (1988).

A bank account subject to a bank's setoff right is clearly "cash collateral." As one noted authority stated,

> [t]he language of section 363(a) is intentionally broad to deal with situations where the property concerned is not strictly collateral. To illustrate, a bank stayed from setting off under section 362(a)(7) would be treated as the holder of a secured claim under section 506(a) to the extent of the deposit

account and the deposit account is considered as "cash collateral" under section 363(a).

2 *Collier on Bankruptcy, supra*, ¶363.02, at 363-16. Numerous courts are in accord. *See, e.g., Kenney's Franchise Corp. v. Central Fidelity Bank, N.A.*, 22 B.R. 747, 750 (W.D. Va. 1982); *In re Williams*, 61 B.R. 567, 571 (Bankr. N.D. Tex. 1986) (a Chapter 11 case); *In re Owens-Peterson*, 39 B.R. 186, 189 (Bankr. N.D. Ga. 1984) (a Chapter 13 case); *In re Gazelle, Inc.*, 17 B.R. 617, 620 (Bankr. W.D. Wisc. 1982).

Section 363 imposes limits on what a debtor in possession or trustee in bankruptcy may do with cash collateral. Section 363(c)(2) provides:

> (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –
>
> (A) each entity that has an interest in such cash collateral consents; or
>
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

11 U.S.C. §363(c)(2) (1988).[9] Thus, the use of cash collateral by the debtor or trustee is restricted by the terms of §363 unless the creditor consents to use of the cash collateral or the court authorizes such use. *See In re Williams*, 61 B.R. 567, 572 (Bankr. N.D. Tex. 1986). This provision exists for the protection of the secured creditor: "The protection is offered not by reason of any non-bankruptcy law limitations inherent to cash collateral but rather in recognition of the unique nature of cash collateral and the risk to the entity with an interest

[9]Section 363(c)(2) applies to debtors in possession by virtue of 11 U.S.C. §1304(b).

therein arising from consumption of the collateral in a rehabilitative effort in bankruptcy." 2 *Collier on Bankruptcy, supra*, ¶363.02, at 363-16.

The protections afforded a creditor for its cash collateral extend further. Section 363(c)(4) provides that a trustee must segregate and account for any cash collateral in the trustee's possession, custody and control. 11 U.S.C. §363(c)(4) (1988). Section 363(e) further provides in relevant part:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

11 U.S.C. §363(e) (1988). Consistent with this restriction, a debtor proposing to use cash or cash equivalents held by a creditor with a right of setoff may be denied use of the cash without first providing adequate protection for the creditor's interest. *See, e.g., In re Hooper*, 152 B.R. 309, 310 (Bankr. D. Colo. 1993); *In re Johnson*, 136 B.R. 306, 311 (Bankr. M.D. Ga. 1991) (both holding that a debtor must demonstrate that the IRS was adequately protected before the IRS would be required to issue a tax refund check subject to IRS setoff). *See also* 2 *Collier on Bankruptcy, supra*, ¶363.06, at 363-30 to 363-35 (where cash subject to setoff is proposed to be used, adequate protection must be furnished before action is taken to use cash collateral).

Sections 362 and 363 thus provide protections, rights and limits for the debtor and the creditor with respect to the creditor's exercise of its right to set off prepetition obligations against each other. Section 362 operates to

stay the exercise of the right of setoff until the creditor has obtained the court's permission, and §363 serves to protect the creditor from losing the right as a result of the debtor's dissipation of the property securing the right. Applied to the facts of this case, §362 operated to delay the ultimate exercise of Citizens' right to set off the amount due under the Note against money in the Debtor's account. The automatic stay did not, however, eliminate Citizens' setoff right.

3. A Bank's Right to Refuse to Turn Over to a Debtor Funds on Deposit and Subject to Setoff is Expressly Recognized by Section 542(b).

A creditor's setoff right against a debtor and his bankruptcy estate is further protected by §542(b) of the Bankruptcy Code. Section 542(b) generally covers the subject of "turnover" of property of the estate; that is, when third parties holding possession of property of a bankruptcy estate must deliver the property to the trustee or debtor in possession. Section 542(b) plainly authorizes a creditor not to pay a debt to the debtor to the extent that such debt is subject to setoff:

> (b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.*

11 U.S.C. §542(b) (1988) (emphasis added).

The operation of §542(b) is best illustrated outside the bank-depositor context. In the case of *In re Whitman*, 38 B.R. 395 (Bankr. D.N.D. 1984), a commissioned salesman was both a customer and employee of a corporation. As an employment benefit, the salesman obtained a discount on products he purchased from the corporation for personal use. Over time, the salesman purchased $4,215.01 worth of product, and in that same period earned $2,265.92 in unpaid sales commissions. After the salesman filed for bankruptcy relief, he instituted a turnover action under §542 of the Bankruptcy Code demanding that the corporation pay him his commissions. The court correctly held that, by operation of §542(b), the corporation was entitled to refuse to pay the commissions because of its right of setoff against those funds, and the debtor's turnover request was denied.

Application of §542(b) in a bank-depositor context is no different. Because the funds in a deposit account constitute a debt owed by the bank to its customer, the bank may refuse to pay that debt, *i.e.*, release the funds in the account, to the extent that it has a right of offset against the funds.

The leading bankruptcy treatise agrees with this view: "If the deposit account may be set off against a debt owed by the debtor to the bank, then turnover of the deposit account must be made *except to the extent the account may be set off against the debt under section 553.*" 4 *Collier on Bankruptcy, supra*, ¶542.03, at 542-15 (emphasis added). *Accord In re Edgins*, 36 B.R. 480, 483 (Bankr. 9th Cir. 1984); *In re Carpenter*, 14 B.R. 405, 407-08 (Bankr. M.D. Tenn. 1981). The commentators who have analyzed this issue also generally agree with this conclusion. *See* Russell J. Passamano, *Setoff in Bankruptcy: An Overview of the Mechanics*, 105 Banking L. J. 349, 358 (1988). *See also* Benjamin Weintraub & Alan N. Resnick, *Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code*, 100 Banking L. J. 316 (1983). Applied to the facts of the

instant case, §542(b) expressly permitted Citizens to refuse to turn over funds from the Debtor's account to the extent Citizens claimed a right of setoff in those funds.

C. The Interplay of the Five Relevant Bankruptcy Code Sections—§§362, 363, 506, 542 and 553—Gives Rise to a Purposeful Statutory Equilibrium Between the Competing Rights of the Debtor and the Bank Creditor to Funds in a Bank Account.

The restrictions on the exercise of the right of setoff by a creditor on the one hand, and on a debtor's ability to use and obtain a turnover of funds on the other, give rise to a purposeful statutory equilibrium appropriately described by one court as a "stalemate." *Edgins*, 36 B.R. at 483. By virtue of §362(a)(7), a creditor may not exercise its right of setoff absent relief from the automatic stay. From the debtor's perspective, §363(c)(2) restricts the debtor's use of funds that are subject to setoff and deemed cash collateral. The debtor also lacks free access to the funds because §542(b) expressly allows a creditor to refuse to pay a debt that is subject to setoff.

The Bankruptcy Appellate Panel of the Ninth Circuit in *Edgins* described the possible resolutions to this statutory equilibrium in the bank-depositor context as follows:

> This stalemate may be alleviated by either party initiating a number of alternative proceedings in the bankruptcy court. Either party might make application for a declaratory determination of whether the frozen account is security by virtue of Section 506(a) and thus subject to a right of setoff under Section 553. The creditor might bring an action for relief from the automatic stay for the purpose of asserting and exercising its security interest and right to setoff. The debtor might bring a motion for use of the security as cash collateral under 11 U.S.C. Section 363. Any of these methods could be pursued by motion and in a shortened time frame, given an emergency. The bankruptcy code does not specify which should be used nor whether the creditor or the debtor should initiate action to break what appears to be a statutory logjam.

Edgins, 36 B.R. at 483. *See also* Weintraub & Resnick, *supra*, at 3-4.

In the present case, the statutory stalemate took effect upon the Debtor's bankruptcy filing. The parties' respective obligations relating to the Debtor's bank account and the Note were created prebankruptcy and were unquestionably mutual. *See supra* at 3-4. Citizens' preexisting common law and contractual right to set off against the Debtor's bank account an amount equivalent to what the Debtor owed Citizens under the Note was preserved under §553. While Citizens was stayed from exercising its right of setoff without bankruptcy court approval, Citizens was entitled under §542(b) to decline to pay the Debtor from his account an amount equal to the sum outstanding on the Note, absent a court order to the contrary.

II.
THE IMPOSITION OF AN ADMINISTRATIVE HOLD DOES NOT VIOLATE THE AUTOMATIC STAY.

A. An Administrative Hold is Not a Setoff and Does Not Violate Section 362(a)(7).

The Fourth Circuit's analysis below focused on the propriety and effect of the administrative hold placed on the account by Citizens. As explained below, the mere imposition of an administrative hold or "freeze" such as the one employed by Citizens is not an act of setoff as contemplated by §362(a)(7), because it is not the result of an intent to set off money in a debtor's account and does not represent affirmative action to effectuate that intent.

While many creditors with a right of setoff may exercise their rights under §542(b) by simply informing a debtor that they choose not to pay their debt subject to a setoff, a financial institution does not have the luxury of simplicity. Financial institutions face significant communicative, technological and geographical difficulties in manifesting an intent and implementing a decision not to pay. Funds in a demand deposit or checking account in most financial institutions are easily accessible in various ways. The account holder may write a check, which comes to the bank through collection channels from another institution or is personally presented by the individual or entity to whom the check is drawn. The account holder may appear in person and make a withdrawal over the counter at any number of bank branches. The depositor may also access funds from automated teller machines all over the country, if not the world. The funds in a bank account can be disbursed to a third party pursuant to an agreement with the bank, for example, in a monthly "bill pay" arrangement. Bank

funds may also be transmitted by electronic transfer in response to a request from the depositor or a third party.

A financial institution must have a mechanism to communicate its decision to exercise its right under §542(b) not to permit withdrawal of funds subject to setoff to multiple branches, automated teller machines, and others with responsibility for administering bank accounts. The solution is the administrative hold or "freeze." The hold is accomplished by electronically coding a financial institution's computers to restrict access to specific funds, and is the most efficient procedure—indeed, the *only* procedure—by which a bank may ensure institution-wide compliance with its internal account-related directives. Ultimately, it is nothing more than a bank's means of communicating to various bank personnel and computers its intent not to pay its debt to its depositor.

Because the timing of a setoff may affect priorities among competing creditors, some states have developed precise tests to determine just when a setoff has occurred. No reported Maryland case has directly addressed this question. However, the predominant and better view among jurisdictions that have formulated such tests requires evidence of an intent to set off coupled with action effectuating that intent. In the leading case of *Baker v. Nat'l City Bank of Cleveland*, the Sixth Circuit stated:

> [T]he act of setoff is not complete until three steps have been taken: (1) the decision to exercise the right, (2) some action which accomplishes the setoff and (3) some record which evidences that the right of setoff has been exercised.

511 F.2d 1016, 1018 (6th Cir. 1975). The test for setoff articulated in *Baker* has been cited repeatedly with

approval. *See, e.g., Horton Dairy, Inc. v. United States*, 986 F.2d 286, 291 (8th Cir. 1993); *United States v. Central Bank of Denver*, 843 F.2d 1300, 1310 (10th Cir. 1988); *In re Saugus Gen. Hosp., Inc.*, 698 F.2d 42, 47-48 (1st Cir. 1983). *See also* 4 *Collier on Bankruptcy, supra*, ¶553.02, at 553-12.[10]

The language of §542(b) supports the distinction between declining to pay a debt that is subject to setoff and the actual exercise of the setoff right. Section 542(b) states that an entity that owes a debt to the debtor must pay that debt except to the extent that such debt "*may* be offset." 11 U.S.C. §542(b) (1988) (emphasis added). The quoted language contemplates that the right of setoff need not yet have been exercised. The Bankruptcy Code thus implicitly recognizes a distinction between declining to pay a debt that is subject to setoff, and the actual exercise of the setoff right. *In re Moreira*, 173 B.R. 965, 966-67 (Bankr. D. Mass. 1994); *In re Carpenter*, 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981).

Presumably because some courts have failed to make the critical distinction between preserving and exercising the right of setoff, the most recent report of the National Bankruptcy Conference's Code Review Project[11] sug-

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[10] "A setoff occurs only when the creditor has sufficiently demonstrated an intent to set off. The setoff does not arise automatically merely because the creditor and the debtor have mutual debts, but only occurs where there has been a deliberate, overt action showing that the creditor has exercised its right of setoff."

[11] The National Bankruptcy Conference is a voluntary, nonprofit organization of about sixty lawyers, law professors, and bankruptcy judges who have achieved scholarly distinction in the field of bankruptcy law. Its purpose is to study in a continuing program the operation of bankruptcy and related laws and to consult with Congress from time to time on needed revisions. The National Bankruptcy Conference's Code Review Project, *Foreword* to Reforming the Bankruptcy Code at i (1994).

gested that §542(b) be clarified to ensure that it is interpreted and followed in the bank-depositor context consistent with its operation in the usual nonbank context. The report stated:

> Language should be added emphasizing that the right not to pay over a debt to the extent it is subject to a setoff right (a provision already in section 542(b)) means that a party may refuse to pay over such debt (*or "freeze" an account that represents a debt owing to the debtor*) without violating the automatic stay.

The National Bankruptcy Conference's Code Review Project, Reforming the Bankruptcy Code 256 (1994) (emphasis added). The Conference recognized that courts which have determined that the imposition of an administrative hold violates the automatic stay have either failed to appreciate that deposit accounts represent debts owed by the bank or have failed "to recognize the existence of section 542(b)." *Id.* at 257.

In the instant case, Citizens' actions clearly stopped short of accomplishing a setoff. Citizens filed its motion seeking relief from the stay under §362(d), seeking permission to exercise its setoff right, contemporaneously with its imposition of the administrative hold on a portion of Strumpf's account. In doing so, Citizens evidenced its intent to delay the exercise of its right of setoff pending bankruptcy court approval. The balance of the account was not reduced by the amount of setoff, and Citizens in all respects acted in a manner evidencing that a setoff had not been taken.

B. An Administrative Hold is Not an Act to Exercise Control Over Property of the Estate.

In addition to staying a creditor's exercise of the right of setoff, the automatic stay prohibits creditors from taking acts to exercise control over property of the bankrupt's estate. Section 362(a)(3) states in pertinent part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of–
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> * * * *
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.

11 U.S.C. §362(a)(3) (1988).[12] The imposition of an administrative hold on a bankrupt depositor's account does not violate §362(a)(3) because the funds in the account are property of the bank, not the estate.

When a bank depositor files for bankruptcy relief, his claim against the bank, not the money in his account, becomes the property of the estate under 11 U.S.C. §541(a)(1). *See Bank of Marin v. England*, 385 U.S. 99, 101 (1966); *Barnhill v. Johnson*, 503 U.S. 393, 112 S. Ct. 1386, 1389 (1992) ("[a] person with an account at a bank enjoys a claim against the bank for funds in an amount equal to the account balance."). This is because the deposits in the account are property of the bank, not the depositor. *See supra* at 13-14; *Keller v. Fredericktown*

[12] Although the Fourth Circuit in *Strumpf* did not consider other provisions of §362(a), some other courts have found the imposition of an administrative hold to be a violation of §362(a)(3). *See, e.g., In re Wicks*, 176 B.R. 695 (Bankr. E.D.N.Y. 1995).

Sav. Inst., 193 Md. 292, 296, 66 A.2d 924, 926 (1949) ("the bank owns the money deposited, subject to the right of the depositor to draw on it."). Where a bank asserts a right of setoff and freezes the debtor's account, the debtor's claim to the bank account (*i.e.*, the estate's property) is not affected in any way by the imposition of the hold, except to the extent permitted by §542(b). Accordingly, an administrative hold, by which a bank ensures that it does not pay its debt to the debtor pending determination of the bank's setoff right, is not an exercise of control over property of the estate in violation of §362(a)(3). *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994); *In re Air Atlanta, Inc.*, 74 B.R. 426, 427 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987).

III.
THE FOURTH CIRCUIT'S ANALYSIS IN *STRUMPF* IS INCOMPLETE AND FLAWED.

The Fourth Circuit made five fundamental mistakes in concluding that an administrative hold on bank deposit funds subject to setoff was a violation of the automatic stay. The lower court (1) ignored the effect of §§363, 506(a), and 542(b) of the Bankruptcy Code; (2) failed to recognize that the bank deposit funds belonged to Citizens, not the Debtor; (3) in effect erroneously concluded that the automatic stay was intended to defeat a creditor's right of setoff, despite other provisions of the Bankruptcy Code and legislative history expressly to the contrary; (4) incorrectly equated an administrative hold to a setoff; and (5) relied on precedent from other jurisdictions having little, if any, relevance to the present case and which is otherwise unpersuasive.

A. Failure to Address All the Relevant Code Sections

The Fourth Circuit panel did not consider the interplay between the five different sections of the Bankruptcy Code which bear directly on the issue presented here. Instead, the lower court's opinion focused only on §§362(a)(7) and 553. In doing so, the Fourth Circuit ignored the impact of §§363, 506(a) and 542(b).[13]

In a remarkably prescient article, two of the foremost bankruptcy commentators predicted that the precise outcome reached by the Fourth Circuit would result from its flawed analysis:

> The seemingly uncomplicated question of whether a bank owed money by its customer may temporarily freeze the customer's account upon learning of its bankruptcy cannot be answered adequately without considering the interplay of several Code provisions. When only Sections 553(a), recognizing the right of setoff, and 362(a)(7), applying the automatic stay to setoffs are considered . . . an erroneous conclusion is reached which prohibits the freezing of funds without court approval.

Weintraub & Resnick, *supra*, at 324. The Fourth Circuit did not appreciate that under §542(b) Citizens had a right to refuse to pay its debt to the Debtor, and that Citizens' declination to pay its debt to Strumpf did not equate to a setoff or an act to exercise control over property of the estate.

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[13]The Fourth Circuit did mention §§506(a) and 542(b) in passing in a footnote, but did not analyze the relevance of these sections to this case. *Strumpf*, 37 F.3d at 157 n.*.

B. Failure to Recognize the Debtor-Creditor Nature of Citizens' Account Relationship With the Debtor

Nowhere in the *Strumpf* opinion did the Fourth Circuit discuss the debtor-creditor relationship between Citizens and the Debtor that was created upon Strumpf's first deposit into his account. Rather, the *Strumpf* court seemingly held the common lay perspective that the money in the Debtor's account was the property of the Debtor, merely held by Citizens for his use. Premised on this misconception, the Fourth Circuit concluded that the Debtor had a right to withdraw all funds in his account while his bankruptcy case was pending: "Whether the creditor actually offsets the debtor's account or places a hold on the debtor's account, both effectively deprive the debtor of the use of the funds pending the outcome of the motion for relief from the stay." *Strumpf*, 37 F.3d at 158 (citation omitted).

C. Erroneous Conclusion that Section 362(a) Was Intended by Congress to Defeat the Right of Setoff

The Fourth Circuit's decision wrongly suggests that Congress intended a debtor to have the ability to defeat a creditor's right of setoff by moving quickly to withdraw funds before the creditor can obtain relief from the automatic stay. In the words of the Fourth Circuit, "[w]hile the banker's dilemma may allow a debtor to defeat a creditor's right of setoff, the clear and unambiguous language of 362(a) produces this result." *Strumpf*, 37 F.3d at 159.

The automatic stay was designed to be just that—a *stay*. While the Code itself is clear enough on this point, the legislative history answers any doubt on the point:

> Paragraph (7) stays setoffs of mutual debts and credits between the debtor and creditors. As with all other paragraphs of subsection (a), this paragraph does not affect the rights of creditors. It simply stays its enforcement pending an orderly examination of the debtor's and creditor's rights.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 342 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6298; S. Rep. No. 95-989, 95th Cong., 2nd Sess. at 51 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 5837. The automatic stay thus was intended to serve as a shield, not a sword capable of severing interested parties from their vested rights:

> The shield of 11 U.S.C. Section 362, which is procedural and vests no intrinsic interest in property to the estate, should not be used as a sword to divest other parties of legitimate interests in property particularly where the debtor has the knowledge and means to bring whatever claim he may have for use of the funds on for prompt hearing.

Edgins, 36 B.R. at 484.

The Fourth Circuit's interpretation of §362(a) renders §§363(c)(2) and 542(b) nullities, and §553 meaningless, as applied to depository institutions. Such an interpretation violates the fundamental maxim that a statute must, if possible, be construed so that every word has some operative effect. *See United States v. Nordic Village, Inc.*, 503 U.S. 30, 36 (1992). *See also Weinberger v. Hynson, Westcott and Dunning, Inc.*, 412 U.S. 609, 631-32 (1973) (separate provisions of the same act are to be given a harmonious and comprehensive meaning, citing *Clark v. Uebersee Finanz-Korporation, A.G.*, 332 U.S. 480, 488 (1947)).

D. Incorrectly Equates an Administrative Hold With a Setoff

The Fourth Circuit incorrectly held that an administrative hold is tantamount to the exercise of a right of setoff and, thus, is violative of §362(a)(7). *Strumpf*, 37 F.3d at 158. As demonstrated above, *see supra* at 26-29, the imposition of an administrative hold is not a setoff, nor should it be considered tantamount to a setoff. It is the only effective means by which a financial institution may decline to pay its debt to the depositor pursuant to §542(b).

By placing an administrative hold, a financial institution does not change the positions of the parties with respect to their interests in the frozen account. A legal stalemate already exists upon the debtor's bankruptcy filing quite apart from any freeze. The hold does not improve or worsen the bank's position: the bank may not set off the funds in the account, yet it retains the right to use the funds since they remain property of the bank. The hold does not improve or worsen the debtor's position: the debtor may not use the funds, but maintains a claim to the funds. The hold merely preserves the *status quo* until such time as the bankruptcy court can determine the respective rights of the parties.[14] *See Edgins*,

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[14] If the imposition of an administrative hold is accompanied by a motion for relief from the automatic stay, the bankruptcy court will determine the respective rights of the parties in relatively short order. *See* 11 U.S.C. §362(e) (1988); 11 U.S.C.A. §362(e) (1993 & 1995 Supp.). The administrative hold ensures that the *status quo* is preserved during this relatively brief period.

36 B.R. at 484 ("The bank in the case at bar has maintained the status quo without taking action to collect or recover a claim against the debtor. It has simply deferred payment of the funds pending the outcome of any proceedings brought by it or the debtor to determine their use and ownership."); *Stann v. Mid American Credit Union*, 39 B.R. 246, 248 (D. Kan. 1984); *In re Learn*, 95 B.R. 495, 496 (Bankr. N.D. Ohio 1989); *In re Bass Mechanical Contractors, Inc.*, 84 B.R. 1009, 1022-23 (Bankr. W.D. Ark. 1988).

E. Misplaced Reliance Upon *Reynolds*, *Norton*, and *Rinehart*

In equating an administrative hold to a setoff, the Fourth Circuit placed significant reliance upon *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), and *Small Business Admin. v. Rinehart*, 887 F.2d 165 (8th Cir. 1989). *See Strumpf*, 37 F.3d at 158.[15] That reliance was misplaced.

The Fourth Circuit's adherence to the reasoning employed in these three cases is partially attributable to the court's apparent misunderstanding of the nature of a deposit account and the effect of the relevant Bankruptcy Code provisions, especially §542(b). This is

[15]The Fourth Circuit also relied upon *In re Penn Central Transportation*, 453 F.2d 520 (3rd Cir. 1971), *cert. denied*, 408 U.S. 923 (1972). *Strumpf*, 37 F.3d at 158. *Penn Central* involved an entirely different, although facially similar, set of concerns from the present case. There, the defendant banks actually set off debts owed them by a railroad undergoing reorganization, in violation of a court order expressly prohibiting them from taking such action. The banks' appeal focused on the jurisdictional authority of the reorganization court to enter the order prohibiting set off. *Id.* at 521-23. *Penn Central* thus has no relevance here.

hardly surprising, given that all three of the earlier cases suffered from similar shortcomings. The courts in *Norton*, *Reynolds*, and *Rinehart* focused their attentions on the effect of withholding payment of money to the debtor and the similarity of that effect to the consequences of a setoff.[16] None of these cases considered the effect of §542(b) and the rights of the creditor agencies to decline to pay debts subject to setoff. Without understanding that the debtors did not have a unilateral right to access the funds held by the creditor agencies to begin with, it is perhaps understandable that these courts incorrectly perceived the freezes imposed as violations of the automatic stay.

The outcome in *Rinehart* also may have been influenced by the fact that the creditor in the case, the Small Business Administration ("SBA"), attempted to retain possession of a check, which it erroneously received postpetition, that was made payable to the debtors by the Department of Agriculture. The SBA gave the debtors no notice that it had come into possession of the check. *Rinehart*, 889 F.2d at 168. *Norton* also is distinguishable because the creditor there, the IRS, had withheld the debtor's tax refund without contemporaneously requesting relief from the stay, apparently intending to withhold the refund until the case was closed.[17] In both of

[16]It is noteworthy that *Norton* relied upon *Penn Central*, a pre-Code case which did not involve §§363 or 542. *Norton*, 717 F.2d at 773. *Reynolds* liberally adopted the logic of *Norton*, *Reynolds*, 764 F.2d at 1006-07, and *Rinehart* liberally adopted the logic of both *Norton* and *Reynolds*. *Rinehart*, 887 F.2d at 168-69. The *Strumpf* opinion appears to be a continuation of this pattern of reliance on precedent rather than independent analysis of the relevant Bankruptcy Code sections.

[17]It is not clear why the IRS has had difficulty, along with financial institutions, in exercising its setoff rights in bankruptcy.

[footnote continued]

these cases, the government's conduct was susceptible to being viewed by the bankruptcy court as closely equivalent to a setoff.

Furthermore, the relevance of *Norton* as precedent in any jurisdiction but Pennsylvania must be questioned. *Norton* applied Pennsylvania law to determine when a setoff of federal tax liabilities occurs. *Norton*, 717 F.2d at 772. Pennsylvania employs an unusual rule of "automatic setoff," under which a setoff is said to occur as a matter of law at the moment that the creditor's claim matures. *See Pittsburgh Nat'l Bank v. United States*, 657 F.2d 36, 38 (3rd Cir. 1981). Under the "automatic setoff" doctrine of Pennsylvania, the maturation of a debt is deemed to "automatically" cause the setoff by operation of law. *Id.* Since Maryland law, which has no such setoff doctrine, is controlling here, *Norton* is not persuasive authority in this case.

One explanation may be that IRS cases sometimes involved conduct viewed to be inequitable by the bankruptcy court, and the court exercised its equity powers to restrain the IRS from exercising its setoff rights. *See, e.g., In re Cascade Roads, Inc.*, 34 F.3d 756, 763-64 (9th Cir. 1994) (the bankruptcy court found the case "replete with inequitable conduct on the part of the Government"). This explanation, however, only goes so far. For example, in the Eastern District of Pennsylvania, the same bankruptcy judge acknowledged the IRS's right to retain funds to the extent of its setoff right in one case, citing 11 U.S.C. §542(b), *see In re Powers*, 28 B.R. 86 (Bankr, E.D. Pa. 1983) (IRS motion to lift stay granted), while in another case the IRS was held in contempt for withholding payment of an income tax refund to the debtor, *see In re Mealey*, 16 B.R. 800 (Bankr. E.D. Pa. 1982).

F. The Fourth Circuit's Interpretation of the Bankruptcy Code Raises a Serious Constitutional Issue Which Should Be Avoided.

It is a cardinal principle of statutory interpretation that "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intention of Congress." *Edward J. DeBartolo Corp. v. Florida Gulf Coast Bld. & Constr. Trades Council*, 485 U.S. 568, 575 (1988). This approach reflects the concern that courts should not needlessly confront constitutional issues and recognizes that a court will assume that Congress did not intend to infringe upon constitutionally protected liberties. *Id.*

The Fifth Amendment to the United States Constitution provides, in part: "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V. As discussed below, the Fourth Circuit's interpretation of §362(a)(7) may be read to effect an unconstitutional taking of a bank's property—the right of setoff—without adequate compensation. However, this Court need not wrestle with the constitutionality of the Bankruptcy Code as interpreted by the *Strumpf* decision, because the correct and harmonious construction of all the relevant Code sections raises no such constitutional issue.

The right of setoff is similar to a secured creditor's interest in its collateral. Like a mortgage or other security interest, the right of setoff enables a creditor to secure the payment of a debt and to satisfy the debtor's obligation by permitting the creditor to retain funds that he otherwise would be obligated to pay to the debtor. *See*

Barrier v. Marine Midland Trust Co., 263 Md. 596, 607, 284 A.2d 418, 424 (1971) (the right of setoff is an exercisable right that is an incident to the remedy to secure payment of a debt). This similarity between the right of setoff and other types of security interests has been recognized by §506(a) of the Bankruptcy Code, which treats a claim of a creditor that is subject to setoff as a "secured claim" to the extent of the amount subject to setoff. *See supra* at 19.

This Court has recognized the rights of secured creditors to be property interests entitled to Fifth Amendment protection. *See United States v. Security Indus. Bank*, 459 U.S. 70, 74-76 (1982); *Armstrong v. United States*, 364 U.S. 40, 44 (1960) (recognizing protected property interest in materialman's lien under state law); *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 279-81 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594 (1935) (mortgagee's rights were property interests protected by the Fifth Amendment). The right of setoff likewise should be recognized as a protected property right.

Congress' bankruptcy power under Art. I, §8, clause 4 of the Constitution is subject to the Fifth Amendment's prohibition against the taking of private property without compensation. As stated in by this Court in *Security Industrial*:

> [H]owever "rational" the exercise of the bankruptcy power may be, that inquiry is quite separate from the question whether the enactment takes property within the prohibition of the Fifth Amendment.

459 U.S. at 75. *See also Radford*, 295 U.S. at 589 ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."). Under the Fourth Circuit's interpretation in *Strumpf*, §362(a)(7) may be read to deprive banks of their constitutionally protected property interest in the right of setoff without adequate compensation.

The governmental action in this case, the enactment of §362(a)(7), as interpreted by the Fourth Circuit, would result in the virtual elimination of banks' reasonable expectations relating to the right of setoff.[18] Without the ability to place an administrative freeze on the debtor's account, banks essentially would be compelled to permit the debtor to withdraw funds on deposit (*i.e.*, pay over the debt subject to the bank's right of setoff to the estate), even though those funds secure the debtor's obligations to the bank and represent a debt that the bank may expressly decline to pay under §542(b). Such an interpretation of §362(a)(7) would raise a serious question as to whether the Code operates as an unconstitutional taking without adequate compensation or protection. *See generally Security Industrial*, 459 U.S. at 75-78 (finding governmental action of bankruptcy code destroying property rights of secured party to be an unconstitutional taking). This constitutional issue can and should be avoided by this Court's adherence to the plain language of the Code and the harmonious interpretation of §362(a)(7) with §§553 and 542(b).

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[18] The right of setoff has been embodied in every bankruptcy statute this nation has had, and creditors—particularly banks—have long acted in reliance on it. *In re Applied Logic Corp.*, 576 F.2d 952, 958 (2d Cir. 1978).

IV.

ALLOWING A BANK CREDITOR TO IMPOSE AN ADMINISTRATIVE HOLD PENDING DETERMINATION BY THE BANKRUPTCY COURT OF THE BANK'S SETOFF RIGHT IS CONSISTENT WITH THE POLICY GOALS OF THE BANKRUPTCY CODE.

A. Under *Strumpf*, the Extraordinary Measure of *Ex Parte* Relief Will Become Routine.

The *Strumpf* decision leaves banks with only one method of attempting to prevent the dissipation of the funds to which they claim a right of setoff: initiating immediate *ex parte* litigation in the bankruptcy court upon the first notice that a customer has filed for bankruptcy relief. If banks are required to go immediately into court upon the suspicion that the debtor might attempt to defeat the bank's setoff right, the bankruptcy court system will suffer from a significant increase in frantic litigation and financial institutions and debtors alike will be forced to incur greater expense in legal representation. Even courts that advocate this approach recognize its inherent drawbacks. *See In re Homan*, 116 B.R. 595, 605 (Bankr. S.D. Ohio 1990) ("This court has no desire to add additional proceedings to its existing docket, nor to increase the litigation expenses of parties in Chapter 13 cases"). Under the Fourth Circuit's holding in *Strumpf*, requests for emergency relief will become routine in federal bankruptcy courts.

Ex parte litigation, however, will not provide financial institutions with complete protection and is not a meaningful substitute for an administrative hold. If banks are denied the ability to freeze funds in which they claim a right of setoff, they must move for *ex parte* protection immediately upon becoming aware of the commencement of the bankruptcy case. Where a depositor sends

notice of his bankruptcy filing, or the bank learns of the filing through a notice to creditors, prior to the depositor's withdrawal of his funds, *ex parte* relief may be effective. However, if the bank learns of the filing contemporaneously with a request for turnover of the funds, *ex parte* action would not be effective. *See In re Moreira*, 173 B.R. 965, 968 (Bankr. D. Mass. 1994). If the request for turnover is in the form of an over-the-counter withdrawal, the bank cannot stall its depositor while its attorneys run into court.[19] The same is true for automated teller withdrawals, electronic transfer requests, automatic bill pay arrangements, and other instantaneous means by which funds are withdrawn from a bank account. If the request for turnover comes in the form of a check, the bank must have its attorneys and the judicial system act within the statutory midnight payment deadline for such instruments. *See In re Patterson*, 967 F.2d 505, 511 (11th Cir. 1992) (discussing the speed with which a bank must act to obtain *ex parte* relief under the midnight payment deadline). If *ex parte* relief is the only means available to a bank to protect its rights, the bank thus faces a substantial possibility of having no protection whatsoever.

Furthermore, banks deprived of the ability to protect their security in the event of a customer's bankruptcy (or faced with the prospect of expensive *ex parte* litigation)

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[19] Depending on the account type, for example, a certificate of deposit, a bank may have a contractual or other right to delay payment to its depositor. However, if the account is a standard checking account, like Strumpf's, or a demand deposit account, in the usual course of business a bank must pay its depositor immediately.

will have a strong incentive to accomplish setoff before the prospective debtor files a bankruptcy petition. The adoption of an interpretation of the Bankruptcy Code which encourages banks to set off debts prior to bankruptcy filings can only lead to a worsening of the financial positions of their customers, thereby possibly necessitating, or at least hastening, a bankruptcy filing.

B. *Strumpf* May be Read as Requiring All Creditors to Turn Over Property Subject to a Setoff Right Upon Demand.

By denying a bank the right to impose an administrative hold, the Fourth Circuit in *Strumpf* effectively held that a bank cannot independently exercise its choice under §542(b) not to turn over property in which it claims a right of setoff. A bank must immediately turn over the subject funds (by, for example, permitting a withdrawal or honoring a check) or violate §362(a). The logic of *Strumpf*, if adopted by this Court, necessarily would apply outside of the bank-depositor context.

Under the intepretation adopted by the Fourth Circuit, any debtor could demand immediate payment of a debt owed to him by a creditor, despite the creditor's assertion of a right of setoff. For example, an impecunious debtor, "B", has an outstanding, mature and unsecured debt of $10,000.00 owing to a creditor, "A", and A owes B $7,500.00. Both obligations arose prior to B's bankruptcy filing and are unquestionably mutual. Under *Strumpf*, B may approach A and demand immediate payment of the $7,500.00 debt (the equivalent of a withdrawal demand). A would not be able to decline to pay and seek relief from the automatic stay from the bankruptcy court to set off the $7,500.00 against B's $10,000.00 debt. Instead, A would be required to turn

over the $7,500.00 to B, and be relegated to receive from B's bankruptcy estate a prorated distribution of funds available for general creditors, which often is little or nothing. The injustice is obvious: A has been forced to pay B, but B, who is bankrupt, may end up paying little or nothing of his $10,000.00 debt to A. Thus, B, under the decision below, would be able to use the Bankruptcy Code to divest the creditor, A, of A's setoff right for B's own enrichment.

In a perfect world, the statutory stalemate between a bank creditor and a debtor which is created upon the debtor's bankruptcy filing, *see supra* at 24-25, should ensure that cash collateral is not dissipated. *See in re Wildcat Constr. Co., Inc.*, 57 B.R. 981, 985-86 (Bankr. D. Vt. 1986) ("Since, if the bank is right about the status of the funds it is holding in the debtor's accounts, the debtor may not use this cash collateral in any event, freezing the accounts hardly seems necessary. . . . We refuse to presume either that most debtors are profligate or that most banks are avaricious."). However, this is not a perfect world and harsh reality requires, and the Code permits, a bank to be allowed to impose an administrative hold on a debtor's account. As one commentator noted:

> If this were Camelot, these provisions of the Bankruptcy Code [§§ 362(a), 363, 506(a), 542(b), and 553] would, by themselves, impose the "freeze." Bankers would not put administrative holds on debtors' bank accounts and debtors would not attempt to withdraw funds from the account without the bank's permission or a court order obtained upon a showing of adequate protection.

Paul S. Groschadl, *"Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?*, 57 Am. Bankr. L. J. 75, 77 (1983).

If denied the ability to use a temporary hold, a financial institution would have no means of preventing its depositor from drawing on his account. As noted in the *Edgins* case:

> Creditors with a valid right of setoff under 11 U.S.C. Section 553 would be required to turnover to the debtor funds subject to setoff and thereafter attempt to obtain an order from the court to preclude the debtor from improvidently dissipating the funds. *This will, all too often, be an attempt to lock the barn door after the horse has been stolen.*

Edgins, 36 B.R. at 484 (emphasis added). A setoff against an account with no funds is a meaningless act, and no effective remedy exists by which a creditor can retrieve the improperly removed funds. *See Williams*, 61 B.R. at 575.[20] In view of the extreme liquidity of funds on deposit, "permitting the temporary freeze serves to give banks needed protection against the immediate dissipation of its cash collateral and resulting destruction of its right of setoff before it has an opportunity to be heard in a bankruptcy court." Weintraub & Resnick, *supra*, at 324.

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[20] "Once cash collateral has been dissipated and spent, court-fashioned sanctions such as retroactive adequate protection, appointment of a Chapter 11 trustee or prohibitions against the further use of cash collateral can be hollow victories for a secured creditor and do not rise to the level of a 'remedy.' This is especially true where all remaining property of the estate is encumbered and the cash which has been spent without permission cannot be replaced." *Id.* As a legal matter, a bank's release of funds may be viewed as a waiver and extinguish the bank's right of setoff. *See* Uniform Commercial Code §9-306(2) (1978). *See also, In re Archer*, 34 B.R. 28, 30 (Bankr. N.D. Tex. 1983) (release of funds could extinguish setoff rights although monies constitute cash collateral, but holding that no waiver occurred).

The facts of this case vividly demonstrate the consequences of depriving a financial institution of its right to freeze a bank account pursuant to §542(b). Citizens initiated the process of determining the parties' competing rights in the funds in the Debtor's account by moving for relief from the automatic stay. (J.A. 15a). The Bank imposed an administrative hold due to its concern that if the account was not frozen Citizens later would have nothing to set off. Only *after* Citizens had requested the bankruptcy court to grant relief did Strumpf move to force Citizens to turn over the funds in which Citizens claimed a setoff right.[21] (J.A. 23a); (R. 1) (Strumpf's motion seeking release of administrative hold and turnover of funds). Ironically, althought the bankruptcy court heard Citizens' motion for relief first, and later heard Strumpf's motion for contempt, the court ruled on the contempt motion and found Citizens in contempt *before* allowing it to exercise its valid right of setoff. (J.A. 27a, 29a). As Citizens predicted, by the time the bankruptcy court subsequently ruled on Citizens' motion, Citizens' cash colateral was gone. The relief from the automatic stay granted by the bankruptcy court to Citizens was a meaningless and Pyrrhic victory. A right of setoff without anything to set off against is "worth little more than the book in which it is found." *In re Davis*, 889 F.2d 658, 662 (5th Cir. 1989), *cert. denied*, 495 U.S. 933 (1990).

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[21] Of course, a motion for turnover under §542 is one of the proper methods by which a debtor can obtain authorization to use funds claimed by a creditor under a setoff right. *See Edgins*, 36 B.R. at 483 (discussing the various methods parties can use to break the "statutory logjam"). A debtor who genuinely needs the funds for his own use may well be the party who first petitions the bankruptcy court to determine the respective rights involved.

CONCLUSION

The decision of the Fourth Circuit should be reversed and the case remanded for entry of the original Order issued by the district court.

Respectfully submitted,

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APPENDIX

11 U.S.C. §362 (1988)

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of –

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

* * *

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or continuing such stay –

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court

shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than thirty days after the conclusion of such preliminary hearing.

* * *

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11 U.S.C. §363 (1988)

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

* * *

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1304, 1203, or 1204 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (c) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the

court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e), or 362(f) of this title.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

* * *

11 U.S.C. §506 (1988)

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

* * *

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11 U.S.C. §542 (1988)

(a) Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

(c) Except as provided in section 362(a)(7) of this title, an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate, or pay a debt owing to the debtor, in good faith and other than in the manner specified in subsection (d) of this section, to an entity other than the trustee, with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced.

* * *

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11 U.S.C. §553 (1988)

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that–

(1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title;

(2) such claim was transferred, by an entity other than the debtor, to such creditor–

(A) after the commencement of the case; or

(B) (i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent; or

(3) the debt owed to the debtor by such creditor was incurred by such creditor–

(A) after 90 days before the date of the filing of the petition;

(B) while the debtor was insolvent; and

(C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in sections 362(b)(6), 362(b)(7), 362(b)(14), 364(h)(2) or 365(i)(2), of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any

insufficiency on the date of such setoff is less than the insufficiency on the later of–

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

* * *

Supreme Court, U.S.
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No. 94-1340

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a bank creditor may refuse a Chapter 13 debtor depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff right, without violating the automatic stay under 11 U.S.C. §362(a), especially when the Debtor's Chapter 13 Plan, which treated the bank creditor as an unsecured creditor, has been confirmed after notice without objection by the bank creditor.

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BRIEF FOR THE RESPONDENT

CONSTITUTIONAL, STATUTORY AND RULE PROVISIONS INVOLVED

The relevant provisions of the United States Constitution, the United States Bankruptcy Code and the Local Rules of the United States Bankruptcy Court for the District of Maryland are reprinted in the appendix to this brief.

STATEMENT OF THE CASE

On January 25, 1991, the Respondent David Strumpf (the "Debtor") filed in the United States Bankruptcy Court for the District of Maryland his voluntary petition for relief under Chapter 13 of the United States Bankruptcy Code.[1] Filed together with his voluntary petition was the Debtor's Chapter 13 Statement and Statement of Affairs (R. 1) (Chapter 13 Statement, Statement of Affairs)[2] as well as the Debtor's proposed Chapter 13 Plan. (J.A. 3a); (R. 1). In the Chapter 13 Statement in response to Question 12(c), the Debtor included among his unsecured debts an indebtedness owed to the Petitioner Citizens Bank of Maryland (hereinafter the "Petitioner" or "Citizens") in the amount of $2,500.00. (R. 1) (Chapter 13 Statement).

On or about February 26, 1991, the bankruptcy court issued its Order for Meeting of Creditors, Combined With Notice Thereof and of Automatic Stays (the "First Meeting Notice") and forwarded the same to all parties-in-interest, including Citizens, (J.A. 7a) together with a copy of the Debtor's proposed Chapter 13 Plan which provided for the treatment of claims of unsecured creditors in Class III thereof. (J.A. 3a). Included among the

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[1] 11 U.S.C. §§101 *et seq.* (1988) (hereinafter sometimes referred to as the "Bankruptcy Code" or the "Code").

[2] Consistent with the treatment of the certified record in the Petitioner's Brief, Respondent notes that the pages of the certified record are not consecutively paginated, and citations to the Record herein are to the Docket Entry in the Record, followed by a parenthetical description of the specific document within the Docket Entry to which citation is made. For example, in this citation, the Chapter 13 Statement and Statement of Affairs may be found at Docket Entry No. 1 of the certified Record; which Docket Entry is the entire Bankruptcy Court record as submitted to the District Court.

important information set forth in the First Meeting Notice was the date and time of the hearing on confirmation of the Debtor's Chapter 13 Plan, which was set for March 20, 1991, at 2:00 p.m. Also included in the First Meeting Notice was a cautionary note that any objections to confirmation of the Plan would be heard at the confirmation hearing. (J.A. 7a).

On March 20, 1991, following due notice thereof, the hearing on confirmation of the Debtor's Chapter 13 Plan was held and the Debtor's Chapter 13 Plan was confirmed; the Order Confirming Plan was thereafter entered on the docket on April 8, 1991. (J.A. 10a-11a).

On June 13, 1991, Citizens filed its Proof of Claim asserting an indebtedness owed to it in the amount of $2,555.50. Other than the filing of its Proof of Claim as aforesaid, Citizens did not avail itself of its right to participate in any way in the Chapter 13 bankruptcy proceeding until October 7, 1991.

On October 2, 1991, Citizens "froze" $3,500.00 maintained by the Debtor in a checking account at Citizens. (J.A. 26a). Five days later, on October 7, 1991, Citizens filed in the bankruptcy court its Motion for Relief from Automatic Stay and for Setoff reciting the existence of a debt owed to it by the Debtor in the aggregate amount of $3,259.68, inclusive of attorney's fees and interest accrued through October 15, 1991—eight days after the date of filing of the Motion. (J.A. 15a-16a).

On October 9, 1991, the Debtor filed his Motion to Hold Citizens in Contempt. (J.A. 23a-25a). In due course, Citizens' Motion for Relief from Stay was heard by the bankruptcy court on November 4, 1991, and ruling was reserved pending the filing of memoranda by

counsel. (R. 1) (Transcript, Nov. 4, 1991 hearing). Shortly thereafter, on November 13, 1991, the bankruptcy court considered the Debtor's Motion to Hold Citizens in Contempt. The bankruptcy court (Paul Mannes, Chief Judge) granted the Debtor's Motion holding Citizens in contempt for violation of the automatic stay and awarded nominal damages of $25.00 to the Debtor together with punitive damages of $375.00 and attorney's fees to Debtor's counsel in the amount of $500.00. (J.A. 27a-28a). Shortly thereafter, following release of the freeze on the Debtor's bank account by Citizens, the bankruptcy court (Paul Mannes, Chief Judge) granted the Motion of Citizens for relief from the stay. (J.A. 29a).

Citizens subsequently appealed the decision of the bankruptcy court granting the Debtor's Motion for Contempt to the United States District Court for the District of Maryland. (R. 1) (Notice of Appeal). On March 30, 1992, the district court (Hargrove, District Judge) reversed the decision of the bankruptcy court by its Memorandum Opinion and Order. (J.A. 31a-38a); *Citizens Bank of Maryland v. Strumpf*, 138 B.R. 792 (D. Md. 1992), *rev'd.*, 37 F.3d 155 (4th Cir. 1994).

The Debtor thereafter appealed the decision of the District Court to the United States Court of Appeals for the Fourth Circuit. On October 13, 1994, the court of appeals reversed the ruling of the district court and remanded the case with instructions to reinstate the decision of the bankruptcy court. (J.A. 39a-46a); *Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155 (4th Cir. 1994). On October 27, 1994, Citizens filed a Petition for Rehearing or, in the Alternative, Suggestion for Rehearing *En Banc* with the Fourth Circuit. On November 8, 1994, that Petition was denied.

On February 6, 1995, Citizens filed herein its Petition for Writ of Certiorari, which Petition was granted by this Court on March 27, 1995.

SUMMARY OF THE ARGUMENT

Debtor filed a Chapter 13 Petition and Chapter 13 Statement listing the unsecured claim of Petitioner Citizens. A Chapter 13 Plan was filed providing for distributions to all unsecured creditors including Petitioner. All creditors were notified of the hearing on confirmation of that Plan and of their opportunity to object. When Citizens failed to object to confirmation and the Chapter 13 Plan was confirmed, Citizens became bound thereby.

Following that confirmation hearing, Citizens took no action to seek a modification of the confirmed Chapter 13 Plan. Some eight (8) months following the filing of the Debtor's voluntary petition under Chapter 13 of the Bankruptcy Code, and some six (6) months following confirmation of the Debtor's Chapter 13 Plan, Citizens unilaterally and without prior notice froze the bank account of the Debtor maintained with Citizens without benefit of any application to or order of the bankruptcy court. Further, Citizens froze funds in the Debtor's bank account in an amount some several hundred dollars in excess of that which Citizens claimed to be owed by the Debtor. By virtue of Citizens' action in freezing the Debtor's bank account, Citizens violated the provisions of 11 U.S.C. §§362(a)(7), (a)(3) and (a)(6).

Notwithstanding Citizens' assertion that its actions in freezing the Debtor's bank account are expressly countenanced by §542(b) of the Bankruptcy Code, careful analysis of that section reveals that the same is simply inapplicable without a prior request to and order from

the bankruptcy court modifying the automatic stays imposed by 11 U.S.C. §362 to permit such a freezing and setoff of the Debtor's bank account.

Further, the assertion by the Petitioner that the imposition of prior relief limitations on its setoff rights is an unconstitutional taking of its property without due process of law in violation of the Fifth Amendment to the United States Constitution is similarly without merit. Throughout the Bankruptcy Code, a careful balance is maintained between the rights of debtors and creditors which sometimes results in the conditioning and/or delay of enforcement of creditors' rights in favor of the Bankruptcy Code's goal of an orderly restructuring of debtor/creditor relationships. As that goal is advanced by the limited restrictions placed upon creditors with rights of setoff without a deprivation of those creditors' rights, there can be no serious argument that those restrictions are an unconstitutional taking of property without due process of law.

Finally, the Respondent states that the *amicus curiae* brief of the United States advances a strained interpretation of the Bankruptcy Code which would eviscerate the debtor protection provisions manifest in 11 U.S.C. §362. Rather than adopt that view, Respondent urges that the statutory scheme can best be preserved and respected through the careful implementation of general or local rules of bankruptcy procedure similar to that adopted by the United States Bankruptcy Court for the District of Maryland and providing an orderly mechanism within the Bankruptcy Code for the processing and setoff of debtors' tax refunds and overpayments.

ARGUMENT

I.

THE CONFIRMATION OF THE DEBTOR'S PLAN FIXED THE RIGHTS OF CITIZENS AND THE TREATMENT TO WHICH ITS CLAIM WAS ENTITLED.

A. Citizens' Failure to Object to the Confirmation of Debtor's Chapter 13 Plan Was a Waiver of Citizens' Right to Object to Its Treatment Therein and Bound It to the Provisions Thereof.

As noted in the Statement of the Case, *supra*, the Debtor's Chapter 13 Plan was filed herein on January 25, 1991, together with the Debtor's Voluntary Petition under Chapter 13 of the Bankruptcy Code. The Debtor filed his Chapter 13 Statement on that date, which included the claim of Citizens in the amount of $2,500.00 as an unsecured claim. On February 26, 1991, the bankruptcy court issued the First Meeting Notice and forwarded the same to all parties in interest, including Citizens, together with a copy of the Debtor's Chapter 13 Plan. Contrary to the assertion of the Petitioner in its brief, the Plan made full provision for the treatment of Citizens' claim together with the claims of all other unsecured creditors in Class 3 thereof (J.A. 3a). The First Meeting Notice further noted that a hearing on confirmation of the Plan would be held on March 20, 1991, at 2:00 p.m., and cautioned as follows:

> IF WRITTEN OBJECTIONS TO CONFIRMATION ARE FILED, A HEARING ON SUCH OBJECTIONS WILL BE HELD AT THE TIME OF THE CONFIRMATION HEARING.

(emphasis in original) (J.A. 7a).

Notwithstanding the treatment of Citizens' claim in the Chapter 13 Plan as unsecured and the bold warning

to all creditors contained in the First Meeting Notice that objections to the Chapter 13 Plan would be considered at the confirmation hearing on March 20, 1991, Citizens took no action and interposed no objection to the treatment provided for it under the Chapter 13 Plan. Accordingly, the Chapter 13 Plan came on for confirmation at the scheduled hearing and was confirmed by order of the bankruptcy court entered on April 8, 1991 (J.A. 10a-11a).

With the entry of the Order Confirming Plan, Citizens was bound to the treatment of its claim contained in the Chapter 13 Plan, pursuant to the provisions of 11 U.S.C. §1327(a). Even following the entry of that Order, Citizens took no action in the Chapter 13 case to assert any claim for different treatment than that proposed for it by the Debtor in his Chapter 13 Plan. While Citizens filed its Proof of Claim in the Chapter 13 proceeding on June 13, 1991, asserting a secured claim in the amount of $2,555.50, it took no action in the bankruptcy court to seek a revision of the Chapter 13 Plan to provide treatment thereunder as a secured creditor. Indeed, other than the filing of its Proof of Claim as aforesaid, Citizens took no action for the first eight (8) months of the Chapter 13 proceedings to assert its right to treatment under the Chapter 13 Plan other than as proposed by the Debtor.

B. Citizens Was Not a Secured Creditor.

Although Citizens asserts that it was a secured creditor in the Chapter 13 proceedings by virtue of its alleged setoff rights and the provisions of 11 U.S.C. §506(a) of the Bankruptcy Code, careful reading of that section makes clear that such secured status does not automatically arise upon the assertion of a right of setoff, but only upon a

determination by the bankruptcy court that a setoff will be permitted in a given case.

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

11 U.S.C. §506(a) (1988).

Indeed, the above-quoted language makes clear the intention of the drafters of the Bankruptcy Code that any party desiring treatment as a secured creditor by virtue of an asserted (but disputed) right of setoff must participate in the hearing on confirmation of the Debtor's Chapter 13 Plan or in some other hearing regarding setoff, or use of funds subject to setoff. The participation of such creditor is required, *inter alia*, because a creditor's right of setoff is permissive in nature, rather than mandatory, and the exercise of setoff is within the discretion of the bankruptcy court under general principles of equity. *Cumberland Glass Mfg. Co. v. DeWitt*, 237 U.S. 447, 455 (1915); *See also In re Blanton*, 105 B.R. 321, 336-38 (Bkrtcy.E.D.Va. 1989) (collecting cases reviewing allowance and disallowance of setoff). Only through a full airing of the creditor's claimed right of setoff at the confirmation hearing, or at some other hearing prior thereto,

can the bankruptcy court consider the equities of the asserted right of setoff, for the purpose of allowing or disallowing a requested setoff, and to determine any secured status pursuant to §506(a). As Citizens did not seek a determination of its alleged secured status at or prior to the confirmation hearing on the Debtor's Chapter 13 Plan, the confirmed Plan represents a judicial determination of Citizens' rights on proper notice to Citizens and to every other creditor. Citizens was bound to the treatment provided in the confirmed Plan, which treatment is as an unsecured creditor. 11 U.S.C. §1327 (a) (1988).

II.

CITIZENS' ACTION IN UNILATERALLY FREEZING THE DEBTOR'S BANK ACCOUNT WAS UNLAWFUL AND VIOLATED 11 U.S.C. §362(a).

A. Citizens Failed to Participate in the Chapter 13 Proceeding; Became Bound by the Provisions of the Confirmed Chapter 13 Plan; and Then Ignored the Confirmation Order and the Bankruptcy Code.

After Citizens' inaction at and prior to confirmation of the Chapter 13 Plan resulted in a determination of its treatment under the Plan, Citizens took no appropriate action to cure what it came to believe was inadequate treatment. While Citizens could have filed an appropriate pleading seeking modification of the Debtor's Chapter 13 Plan to provide treatment for Citizens as a creditor allegedly secured by setoff rights in the Debtor's bank account, or could have filed a Motion seeking relief from the various stays imposed by §362 to permit it to assert and exercise its rights of setoff against the Debtor's bank account, Citizens elected neither of said options. Further, no other judicial remedy was pursued. Instead, Citizens

chose to ignore both the court order confirming the Plan as well as the carefully orchestrated scheme of debt restructuring contemplated throughout the Bankruptcy Code. Citizens unilaterally, and without any recourse to the statutory scheme of the Bankruptcy Code or to judicial determination, setoff the Debtor's bank account in the amount of $3,500.00 as a result of a pre-petition unsecured debt which was no more than $3,259.68.

Indeed, the actions of Citizens to protect its narrow interests some eight (8) months into the subject bankruptcy case in absolute disregard of the rights of all other creditors illumines the wisdom of Congress in its inclusion in the Bankruptcy Code of the automatic stay provisions of 11 U.S.C. §362.[3] Commenting on the purpose of that bedrock provision, the House Committee on the Judiciary noted as follows:

> The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the[ir] claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 340 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787.

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[3] The purpose of the automatic stay, in essence, is to prevent the further desiccation of the debtor's cash flow through the loss of bank accounts and accounts receivable thereby expediting the financial recovery of the debtor. Randy J. Shaw, *Finally, An Answer to the Banker's Dilemma!*, 68 Fla. B.J. 79 (1994).

All creditors, including Citizens, were bound by law to the treatment provided in the confirmed Plan. Citizens acted in derogation of that legal duty, in its own parochial interest, and to the complete disregard of all other parties in interest.

B. Citizens Violated Three Sections of 11 U.S.C. §362(a).

1. The Violation of §362(a)(7).

The Fourth Circuit relied on opinions of numerous other courts of appeals written since the adoption of the Bankruptcy Reform Act of 1979 to support the conclusion that the imposition of an administrative freeze on a debtor's bank accounts is tantamount to a setoff under 11 U.S.C. §362(a)(7). Those opinions firmly establish the principle in those several circuits that the denial to debtors of meaningful and timely access to deposit accounts maintained in the name of those debtors is an exercise of control over property of the debtor's estate in violation of 11 U.S.C. §362(a)(3) as well as a premature attempted setoff of property of the debtor's estate in violation of 11 U.S.C. §362(a)(7). *See In re Patterson*, 967 F.2d 505, 513 (11 Cir. 1992); *United States v. Reynolds*, 764 F.2d 1004, 1007 (4th Cir. 1985); *United States v. Norton*, 717 F.2d 767, 773 (3rd Cir. 1983).

2. The Violation of §362(a)(3).

Although not embraced by the court of appeals, the bankruptcy court below found that Citizens' action in freezing the Debtor's bank account violated the automatic stay's prohibition contained in 11 U.S.C. §362(a)(3). (R. 1) (Transcript, Nov. 4, 1991 hearing). In opinions

of other courts echoing that determination by the bankruptcy court below, those courts have noted the expression of Congressional intent in expanding the ambit of §362(a)(3) by the amendment of that section included in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353. While §362(a)(3) previously proscribed ". . . any act to obtain possession of property of the estate or of property from the estate . . . ," the 1984 amendments substantially strengthened that section by including therein a prohibition against acts ". . . to exercise control over property of the estate. . . ." 11 U.S.C. §362(a)(3) (1988); *See In re Wildcat Constr. Co., Inc.*, 57 B.R. 981 (Bankr.D.Vt. 1986).

Although Citizens properly observes in its brief that the funds in the Debtor's bank acount were not, in and of themselves, property of the estate, *Barnhill v. Johnson*, 503 U.S. 393 (1992), the right to withdraw those funds is property properly included within the pervasive definition of "property of the estate." 11 U.S.C. §541 (1988). That section includes in the definition of "property of the estate" "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a)(1) (1988). The Debtor's right to withdraw funds is at least an equitable right, and as such is included within the property of the Debtor's estate. As such, the unilateral imposition by Citizens of an administrative freeze on the Debtor's bank account was an act which impeded the Debtor's access to his funds and therefore represented the exercise by Citizens of ". . . control over property of the estate. . . ." 11 U.S.C. §362(a)(3) (1988).

3. The Violation of §362(a)(6).

The provisions of 11 U.S.C. §362(a)(6) prohibit "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title. . . ." That section is succinct and not difficult to understand, notwithstanding the obfuscatory efforts of the Petitioner to the contrary. There is no doubt that Citizens' action was in respect of "a claim against the debtor that arose before the commencement of the case. . . ." 11 U.S.C. §362(a)(6) (1988). Similarly, there can be no serious dispute that the act of freezing the Debtor's bank account was designed to collect or recover that claim. *In re Patterson*, 967 F.2d 505, 512 (11th Cir. 1992); *In re Figgers*, 121 B.R. 772, 778 (Bkrtcy. S.D. Ohio 1990). Thus, the violation of §362-(a)(6) is clear and compelling.

While Citizens may ultimately have been entitled to relief from stay had it requested such relief prior to the confirmation of the Debtor's Chapter 13 Plan, the simple fact remains that no relief from the stay was requested or granted, and the act of freezing the Debtor's bank account falls squarely within the proscription of §362(a)(6).

In *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), the court elucidated many of the relevant points in this analysis. The Third Circuit cited the legislative history to remind creditors, and the courts which review their actions, as follows:

> The purpose of chapter 13 is to enable an individual, under court supervision and protection, to develop and perform under a plan for the repayment of his debts over an extended period. In some cases, the plan will call for full repayment. In others, it may offer creditors a percentage of their claims in full

> settlement. During the repayment period, creditors may not harass the debtor or seek to collect their debts. They must receive payments only under the plan. This protection relieves the debtor from indirect and direct pressures from creditors, and enables him to support himself and his dependents while repaying his creditors at the same time.

United States v. Norton, 717 F.2d 767, 773 (3rd Cir. 1983) (quoting H.Rep. 595, *supra* at 118).

The Court then observed that "even creditors whose claims are secured under the Code must submit to the risk inherent in judicial supervision of the rights they normally would have to enforce their claims against property of the debtor." *United States v. Norton*, 717 F.2d 767, 773-74 (3rd Cir. 1983) (citing *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198 (1983)). The Third Circuit further notes that "[s]ection 1322 of the Code specifically authorizes a modification of the rights of most holders of secured claims and all holders of unsecured claims. 11 U.S.C. §1322(b)(2)." 717 F.2d pp. 773-74 at n. 10.

Thus, the complaint made by Citizens in its brief that affirmance by this Court of the decision of the Fourth Circuit will deprive Citizens of its setoff rights existing under state law ignores a central tenet of bankruptcy law—bankrupcy courts are empowered by the Bankruptcy Code to modify the rights of secured and unsecured creditors through the confirmation of a Plan. Such a modification of the rights of Citizens occurred when the Chapter 13 Plan was confirmed by the bankruptcy court below following Citizens' voluntary decision not to participate in the confirmation process. Unfortunately, Citizens' response to that modification of its rights by unilaterally and without prior notice freezing the Debtor's bank account some eight months after filing the

Chapter 13 Petition, and six (6) months after confirmation of the Chapter 13 Plan, violated the automatic stay imposed by §362(a)(6).

C. The Violation of the Stay By Citizens Was Compounded by the Freezing by Citizens of More of the Debtor's Funds Than Required to Protect Its Claim.

Adding insult to the injury inflicted by Citizens upon the Debtor is the fact, glossed over by both the bankruptcy court and the court of appeals below, that Citizens imposed a freeze on the Debtor's bank accounts well in excess of any amount which was then allegedly owed to it by the Debtor. As noted in the Statement of the Case, *supra*, the Debtor acknowledged in his Chapter 13 Statement a debt owed to Citizens in the amount of $2500.00. (R. 1) (Chapter 13 Statement). Indeed, in its Proof of Claim filed on June 13, 1991, Citizens itself asserted a claim of only $2,555.50. (R. 1) (Proof of Claim). Further, in its Motion for Relief from Stay filed five (5) days after its freeze of the Debtor's bank account, Citizens recited a debt owed to it in the total amount of only $3,259.68, inclusive of accrued interest and attorney's fees. (J.A. 15a-16a). Notwithstanding the express acknowledgement by Citizens that it was therefore owed not more than the $3,259.68 set forth in its Motion for Relief from Stay, Citizens had already frozen the sum of $3,500.00 five (5) days before the filing of that Motion—some several hundred dollars in excess of even its own most optimistic accounting of its claim.[4]

[4] Respondent notes that even that sum of $3,259.68 recited in Citizens' Motion for Relief from Stay included interest not yet accrued; the same having been accounted through October 15, 1991—eight (8) days after the filing of that Motion and thirteen (13) days after the freeze of the Debtor's bank account.

Surely such an action, when combined with the extraordinarily dilatory handling of Citizens' claim throughout the Debtor's then eight-month old bankruptcy case, belies any suggestion that Citizens acted in good faith and should be extended the benefits of an equitable view of its claim and alleged setoff rights in respect thereof.

III.

SECTION 542(b) OF THE BANKRUPTCY CODE PROVIDES NO SUPPORT FOR THE ASSERTION BY CITIZENS OF ITS PURPORTED RIGHT OF SETOFF AGAINST THE DEBTOR'S BANK ACCOUNT.

In its brief, the Petitioner asserts that it was expressly authorized by §542(d) to freeze administratively the Debtor's bank account pending prospective determination by the bankruptcy court of Citizens' motion seeking relief from §362(a)(7) to permit setoff of that bank account. It is true that under the plain language of §542 (b), Citizens may decline to turnover debts due by it to the Debtor to the extent Citizens has debts due it from the Debtor, but only to the extent permitted by 11 U.S.C. §553 of the Bankruptcy Code.

By its terms, §553 permits setoff only after compliance by an offsetting creditor with the provisions of §362 of the Bankruptcy Code.

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the

> debtor that arose before the commencement of the case. . . .

11 U.S.C. §553(a) (1988).

In a cogent analysis of the assertion that §542(b) authorizes a freeze of debtors' bank accounts in situations such as are presented in the instant case, the court in *In re Wildcat Constr. Co., Inc.*, 57 B.R. 981 (Bankr. D.Vt. 1986) observed:

> Indeed, perhaps the most fundamental problem with countenancing the freezing of the debtor's bank accounts before any judicial determination of the rights of the parties has been made is that it begs the critical question, assuming in advance the precondition for its validity. This position converts a bank's potential right to setoff into an allowed claim at the outset. These Courts "seem to assume that the bank has the right to make the initial determination of which bank accounts are cash collateral which the debtor may not use. . . ." *Cusanno v. Fidelity Bank*, 29 B.R. at 813. The freeze is essentially an extra-judicial temporary restraining order. We must not delegate to one of the parties the judicial responsibility of deciding whether the funds in the accounts are cash collateral and of enforcing the statutory prohibition against using such cash collateral.

In re Wildcat Constr. Co., Inc., 57 B.R. at 986.[5]

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[5] While the Petitioner spills copious appellate ink in its Brief espousing its assertion that the Respondent was somehow in violation throughout the Chapter 13 case of the proscriptive cash collateral provisions of 11 U.S.C. §363(c)(2), Respondent observes that the instant case is presented to this Court not upon any complaint regarding such alleged unauthorized use of cash collateral, but rather upon the finding by the bankruptcy court and the court

[footnote continued]

Nothing in the instant case prohibited Citizens at any time during the entire eight-month history of the subject Chapter 13 proceedings from seeking authority from the bankruptcy court to setoff the Debtor's bank account. Although Citizens asserts that any filing of a request for relief from the §362 stay would necessarily have alerted the Debtor to Citizens' intentions (and presumably would have triggered a withdrawal of funds from the account by the Debtor), Congress contemplated such a "banker's dilemma" when it enacted 11 U.S.C. §362(f) of the Bankruptcy Code permitting the granting of *ex parte* relief from the stay as required to prevent irreparable damage to creditors such as Citizens. As observed by the Court of Appeals for the Eleventh Circuit in *In re Patterson*, 967 F.2d 505 (11th Cir. 1992):

> Creditors in this position have an alternative remedy and need not freeze debtors' accounts. The creditor may file an ex parte motion pursuant to Sections 362(f) or 363(e) and accompany this motion with the funds from the debtor's account to be paid into the registry of the bankruptcy court. This approach strikes the proper balance between the parties' interests. The creditor is protected from the risk that funds will be insufficient or unavailable to satisfy a later-determined valid right of setoff. The debtor is protected from the risk that a creditor will unilaterally deny the debtor access to funds in

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of appeals that Citizens acted in violation of the fundamental debtor protections afforded by 11 U.S.C. §362. In any event, Respondent notes that the provisions of 11 U.S.C. §363(c)(2) are manifestly inapplicable to a retired individual, such as the Respondent, who is not "engaged in business." See 11 U.S.C. §363(c)(1); 11 U.S.C. §1304. See also, *In re Rio*, 55 B.R. 814, 817 (Bk. Ct. M.D. Ala. 1985) and *In re Wicks*, 176 B.R. 695, 698-99 (Bk. Ct. E.D. N.Y. 1995).

which the creditor does not have a valid right of setoff.

In re Patterson, 967 F.2d at 511.

Unfortunately, the only "banker's dilemma" apparently considered by Citizens herein was whether to expend that effort necessary to avail itself of the very protection inserted by Congress in the Bankruptcy Code to protect creditors in the position in which Citizens found itself. In the instant case, approval by this Court of the dilatory handling by Citizens of its claim and setoff rights against the Debtor would provide to all creditors with similar claims and purported setoff rights a road map for the disingenuous. If Citizens is to be permitted the right to allow the Debtor to propose and obtain confirmation, without objection from Citizens, of his Chapter 13 Plan providing treatment for Citizens as an unsecured creditor, and then blithely to ignore the confirmed Plan in favor of its own draconian implementation of its long-waived setoff rights, great violence will thereby be visited on the careful framework of the adjustment of debtor-creditor relationships contemplated by Congress in enacting Chapter 13 of the Bankruptcy Code.

IV.

THE UNIQUE INTERESTS OF THE UNITED STATES AS WELL AS THOSE OF STATE TAXING AUTHORITIES DO NOT SUPPORT REVERSAL OF THE DECISION OF THE FOURTH CIRCUIT COURT OF APPEALS.

In its *amicus curiae* brief supporting the Petitioner herein, the United States notes its special interest in the issue at bar by virtue of the frequent position of the Government as a creditor seeking to setoff tax refunds and overpayments due to debtors from the Government

against other tax indebtedness owed by those debtors to the Government. (Brief of United States, pp. 1-2).

Implicit in the Government's expressed interest in these proceedings is its legitimate concern that a ruling favorable to the Debtor herein will necessarily thereafter require the Government to engage in widespread litigation in an overwhelming number of bankruptcy proceedings in order to secure for the Government the relief from the automatic stay imposed by 11 U.S.C. §362 necessary to permit it routinely to setoff debtors' tax refunds and overpayments against their pre-existing tax liabilities.

The short answer to the Government' dilemma is that it would be bound to seek prior relief from the automatic stay just as are bank and other non-government creditors, and courts have so held. *United States v. Reynolds*, 764 F.2d 1004, 1006-07 (4th Cir. 1985); *United States v. Norton*, 717 F.2d 767, 773-74 (3rd Cir. 1983) (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983)). Such an abbreviated response need not be the final word with regard to the Government's unique position.

In the District of Maryland, from which this case originates, the bankruptcy court has taken express note of the unique situation of the United States and the State of Maryland by adoption of Local Rule 25 ("Internal Revenue Service and Maryland Income Tax Refunds–Automatic Stay"). That Rule, as set forth in its entirety in the Appendix to this brief, establishes a thoughtful mechanism addressing the legitimate concerns of the Government while not overburdening the bankruptcy court with motions for relief from stay in a large number of those cases filed in that court. The local rule makes

special provision regarding tax refunds to permit the Government and the State of Maryland

> . . . to offset against any refund or overpayment due a debtor, any taxes due to the United States or the State of Maryland, provided that a claim for such taxes has been filed and neither disputed nor disallowed in a federal or state court.

Rule 25(b)(1), Local Rules of the U.S. Bankruptcy Court for the District of Maryland.

In this fashion, the bankruptcy court pays heed to the proscriptive provisions of 11 U.S.C. §362 while providing a practical framework within which necessary setoffs can be made without a plethora of unnecessary litigation. It is respectfully submitted that any impact on the Government or other state taxing authorities as may result from an affirmance herein of the opinion of the Fourth Circuit below can best be addressed through the adoption of a local or general rule by the several bankruptcy courts or this Court similar to that now effective in Maryland.

V.

THE DECISION OF THE FOURTH CIRCUIT COURT OF APPEALS BELOW THREATENS NO CONSTITUTIONALLY PROTECTED DUE PROCESS RIGHTS OF THE PETITIONER OR SIMILARLY SITUATED CREDITORS.

In its brief, Citizens asserts that the ruling of the Fourth Circuit below constitutes a complete usurpation of secured creditors' rights of setoff and, as such, is an unconstitutional taking of property without due process of law in violation of the Fifth Amendment to the United States Constitution. In fact, such a reading of the Fourth Circuit's opinion below is disingenuous, hyperbolic, and incendiary.

Nothing in the Fourth Circuit's opinion below suggests that secured creditors' rights of setoff are vitiated by operation of 11 U.S.C. §362(a)(7); rather, the decision of the Fourth Circuit properly notes that the right of setoff is not without limits and conditions when exercised in the context of a pending bankruptcy proceeding. Specifically, the Fourth Circuit notes that by utilizing the simple expedient of 11 U.S.C. §362(f), Citizens could have achieved complete protection of its right of setoff, while ensuring that no violence was done to the carefully constructed scheme of bankruptcy administration envisioned by the Bankruptcy Code.

In requiring that Citizens seek relief from the bankruptcy court pursuant to the provisions of 11 U.S.C. §362, the Fourth Circuit recognized that the exercise of the right of setoff by Citizens was not at all unlike the exercise by secured creditors of their rights to enforce mortages and deeds of trusts and other security interests in realty and personalty. In such circumstances, while the Bankruptcy Code conditions the rights of those creditors to enforce their security interests by first requiring application to and order from the bankruptcy court permitting the enforcement of their security interests, no security interest itself is lost nor is any right to the enforcement of that security interest. To the contrary, the only limiting factor placed upon those secured creditors is the necessary intervention of the bankruptcy court and the delay incident thereto. This is not an impermissible or unwarranted burden on creditors.

In imposing special conditions and limitations on the exercise of the rights of secured creditors as well as those seeking to exercise rights of setoff, the drafters of the Bankruptcy Code carefully balanced the competing interests of the vested property rights of those creditors

against the legitimate requirements of debtor protection and the goal of orderly restructuring of debtor-creditor relationships manifest throughout the Bankruptcy Code. Courts across the country have acknowledged Congress' express purpose in adopting the statutory scheme in this regard, as did the Fourth Circuit below.

CONCLUSION

The decision of the court of appeals should be affirmed.

Respectfully submitted,

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APPENDIX

RELEVANT CONSTITUTIONAL AND STATUTORY RULES AND PROVISIONS

UNITED STATES CONSTITUTION AMENDMENT V

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

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11 U.S.C. §362 (1988)

§362. Automatic stay

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of –

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title,

or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

* * *

(f) Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

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11 U.S.C. §363 (1988)

§363. Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

(2) If notification is required under subsection (a) of section 7A of the Clayton Act (15 U.S.C. 18a) in the case of a transaction under this subsection, then –

(A) notwithstanding subsection (a) of such section, such notification shall be given by the trustee; and

(B) notwithstanding subsection (b) of such section, the required waiting period shall end on the tenth day after the date of the receipt of such notification, unless the court, after notice and hearing, orders otherwise.

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1304, 1203 or 1204 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (e) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

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11 U.S.C. §506 (1988)

§506. Determination of secured status.

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the

case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

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11 U.S.C. §541 (1988)

§541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

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11 U.S.C. §542 (1988)

§542. Turnover of property to the estate

(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

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11 U.S.C. §1304 (1988)

§1304. Debtor engaged in business

(a) A debtor that is self-employed and incurs trade credit in the production of income from such employment is engaged in business.

(b) Unless the court orders otherwise, a debtor engaged in business may operate the business of the debtor and, subject to any limitations on a trustee under sections 363(c) and 364 of this title and to such limitations or conditions as the court prescribes, shall have, exclusive of the trustee, the rights and powers of the trustee under such sections.

(c) A debtor engaged in business shall perform the duties of the trustee specified in section 704(8) of this title.

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11 U.S.C. §1322 (1988)

§1322. Contents of plan

(b) Subject to subsections (a) and (c) of this section, the plan may –

(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

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11 U.S.C. §1327 (1988)

§1327. Effect of confirmation

(a) The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

LOCAL RULES OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND

Rule 25. Internal Revenue Service And Maryland Income Tax Refunds – Automatic Stay

(a) Refunds. The Internal Revenue Service and the Maryland Comptroller of the Treasury, Income Tax Division, are authorized to make income tax refunds, in the ordinary course of business, directly to debtors in Chapter 7, 12, and 13 cases; provided, however, that in Chapter 7 cases no refund will be made to debtors within sixty (60) days after a petition is filed. Thereafter, unless otherwise directed by the trustee or the Court, a refund may be made directly to the debtor.

(b) Offset; Assessment; Automatic Stay.

(1) The Internal Revenue Service and the Maryland Comptroller of the Treasury, Income Tax Division, are authorized to offset against any refund or overpayment due a debtor any taxes due the United States or the State of Maryland, provided that a claim for such taxes

has been filed and neither disputed nor disallowed in a federal or state court.

(2) The Internal Revenue Service and the Maryland Comptroller of the Treasury, Income Tax Division, are authorized to assess any tax liability that may be satisfied by offsetting an overpayment when such liability has not previously been assessed. Notice of such assessment and offset shall be given to the debtor prior to or substantially concurrently with such assessment and offset.

(3) The Internal Revenue Service and the Maryland Comptroller of the Treasury, Income Tax Division, are authorized to assess, but take no other steps toward collection of, tax liabilities shown on voluntarily filed returns and other agreed-to tax liabilities unless otherwise authorized by this Rule, or by order of court. The exception to automatic stay in 11 U.S.C. §362(b)(9) shall be deemed automatically modified in accordance with the provision of this Rule.

(c) **Notice to Trustee and Court.** The debtor shall, within five (5) days of receipt of a tax refund or notice of tax assessment or deficiency, file with the Court and send to the trustee a copy of the refund check (in Chapter 7 cases) and transmittal letter, the tax assessment or deficiency notice, and other documents evidencing same.

Supreme Court, U.S.
FILED
JUL 12 1995
CLERK

(15)

No. 94-1340

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff right, without violating the bankruptcy stay under 11 U.S.C. §362(a).

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REPLY BRIEF FOR THE PETITIONER

Petitioner, Citizens Bank of Maryland, hereby replies to the arguments set forth in the Brief for the Respondent, and respectfully urges this Court to reverse the decision of the United States Court of Appeals for the Fourth Circuit.

ARGUMENT

I.

STRUMPF'S ARGUMENT THAT CITIZENS WAIVED ITS SETOFF RIGHT IS NOT PROPERLY BEFORE THIS COURT AND IGNORES THE EXPRESS LANGUAGE OF SECTION 553 OF THE BANKRUPTCY CODE.

A. Strumpf's "Waiver" Argument, Not Having Been Raised Below, Has Been Waived.

This Court granted the petition for a writ of certiorari filed by Petitioner, Citizens Bank of Maryland ("Citizens"),[1] to resolve the question presented: "Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending a determination by the bankruptcy court of the bank's setoff right, without violating the bankruptcy stay under 11 U.S.C. §362(a)." *See* Citizens' Petition for a Writ of Certiorari, filed on February 6, 1995 and granted on March 27, 1995. The Respondent and debtor in bankruptcy, David Strumpf ("Strumpf"), attempts to avoid this important issue by asserting as his lead argument, for the first time at any stage of this case, that Citizens waived its setoff right by failing to object to the confirmation of Strumpf's Chapter 13 plan. *See* Brief for the Respondent ("Respondent's Brief") at 7-12.

This argument was never raised below, in the bankruptcy court, the district court, or the court of appeals. Having never been asserted below, Strumpf's waiver argument was never mentioned by either the bankruptcy court or the district court in their respective opinions. (J.A. 27a-38a). The Fourth Circuit likewise did not address the issue in its opinion. (J.A. 39a-46a).

[1] Pursuant to Supreme Court Rule 29.1, Citizens respectfully refers the Court to the Brief for the Petitioner, at 3 n.2, for its parent and subsidiaries list.

Having failed to raise the waiver argument below, it is too late for Strumpf to do so now. This Court pronounced long ago, and reiterated more recently, the prohibition against raising arguments for the first time in this Court:

> Without cross-petitioning for certiorari, a prevailing party may, of course, "defend its judgment on any ground properly raised below, whether or not that ground was relied upon, rejected, or even considered by the District Court or the Court of Appeals," provided that an affirmance on the alternative ground would neither expand nor contract the rights of either party established by the judgment below. . . . Although "we could consider grounds supporting [the] judgment below different from those on which the Court of Appeals rested its decision," "where the ground presented here has not been raised below we exercise this authority 'only in exceptional cases.' "

Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 38-39 (1989) (citations omitted) (citing *Heckler v. Campbell*, 461 U.S. 458, 468 n.12 (1983), quoting *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940)). *See also United States v. Alvarez-Sanchez*, ___ U.S. ___, 114 S. Ct. 1599, 1605 n.5 (1994) ("Finding no exceptional circumstances that would warrant reviewing a claim that was waived below, we adhere to our general practice and decline to address respondent's [new] Fourth Amendment argument."). No exceptional circumstances exist in this case, and this Court should adhere to its general practice and decline to address the issue. It is also this Court's general practice not to consider issues not raised in the petitioner's question presented to the Court. *See Air Courier Conference of America v. American Postal Workers Union, AFL-CIO*, 498 U.S. 517, 111 S. Ct. 913, 917 (1991) (Court rejected

respondent's attempt to raise argument not presented in petitioner's petition for a writ of certiorari). The effect of a Chapter 13 plan confirmation on a creditor with an undisputed right of setoff, where the plan makes no mention of the creditor's setoff right, is not an issue fairly encompassed within the question presented in Citizens' petition for a writ of certiorari, and Strumpf did not file a cross-petition for a writ of certiorari on this new issue. Accordingly, this Court should not consider Strumpf's new "waiver" argument.

Furthermore, Citizens' right of setoff was conclusively determined by the bankruptcy court when it granted Citizens' motion for relief from the automatic stay to set off Strumpf's bank deposits against his obligations to Citizens, and that determination was never appealed. (J.A. 29a-30a). Citizens' entitlement to a right of setoff against Strumpf's bank deposits thus was finally decided and cannot now be questioned. *See Morely Constr. Co. v. Maryland Casualty Co.*, 300 U.S. 185, 191 (1937) (failure to cross-appeal on an issue waives the appellee's right to assert it in the reviewing court).

B. Section 553(a) Of The Bankruptcy Code Expressly Preserves Citizens' Right Of Setoff.

Even if this Court were to depart from its general practice and consider Strumpf's "waiver" argument, the argument should be rejected as without merit. Strumpf cites no case or other authority in support of his argument, other than an unexplained citation to 11 U.S.C. §1327(a). Section 1327(a) simply provides that the terms of a confirmed Chapter 13 plan bind the debtor and each creditor, "whether or not the claim of such creditor is provided for by the plan, and whether or not

such creditor has objected to . . . the plan." 11 U.S.C. §1327(a) (1988).

In this case, Strumpf's Chapter 13 plan provided that unsecured creditors would be paid "pro-rata" from his monthly payments of $100 to the Chapter 13 trustee. Citizens' right to receive payments under the plan as an unsecured creditor is not at issue in this case. The plan makes no mention of Citizens or Citizens' right of setoff, which is the issue before this court. (J.A. 3a-4a). It certainly does not provide that Citizens would forfeit its setoff right against Strumpf's bank deposits at Citizens. *Id.* Accordingly, §1327(a) in no way supports Strumpf's attempt to challenge Citizens' setoff right.

Moreover, Strumpf's argument ignores 11 U.S.C. §553(a), which provides in relevant part:

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . . .

11 U.S.C. §553(a) (1988).[2] Section 553(a), which speceifically governs the treatment of setoff rights in the Bankruptcy Code ("the Code"), thus precludes an argument that §1327(a), or any other Code provision (other than the expressly excepted §§362 and 363),[3] deprived Citizens of its setoff right. *See In re Tillery*, 179 B.R. 576, 578-79 (Bankr. W.D. Ark. 1995) (holding that confirmation of a Chapter 13 plan did not alter the

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[2]The exceptions to the prohibition in §553 against modifying a creditor's setoff right, set forth in 11 U.S.C. §553(a)(1), (2), and (3), have no relevance to this case.

[3]None of the provisions of 11 U.S.C. §§362 and 363 eliminate Citizens' setoff right. *See* Petitioner's Brief at 18-22.

creditor's right of setoff); *In re Olson*, 175 B.R. 30, 32 (Bankr. D. Neb. 1994) (creditor retained setoff right notwithstanding confirmation of a Chapter 13 plan); *In re Whitaker*, 173 B.R. 359, 362-63 (Bankr. S.D. Ohio 1994) (rejecting argument that §1327(a) affected creditor's right of setoff). *See also In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269, 1276-77 (9th Cir. 1992), *cert. denied*, ___ U.S. ___, 113 S. Ct. 330 (1992) (holding no waiver of setoff right in Chapter 11 case).

II.

CITIZENS' REFUSAL TO PERMIT STRUMPF TO WITHDRAW BANK FUNDS PENDING THE BANKRUPTCY COURT'S DETERMINATION OF CITIZENS' SETOFF RIGHT WAS NOT ITSELF A SETOFF AND DID NOT VIOLATE THE AUTOMATIC STAY.

In addressing the question presented, Strumpf argues that Citizens' imposition of an administrative freeze on his bank account, while simultaneously seeking relief from the automatic stay, violated 11 U.S.C. §362(a)(7), (a)(3), and (a)(6). *See* Respondent's Brief at 12-16. These arguments, which for the most part are addressed in the Brief for the Petitioner ("Petitioner's Brief") at 26-31, are unsound. Stated succinctly, "[t]he freeze should not be considered a violation of the stay." 4 James W. Moore & Lawrence P. King, *Collier on Bankruptcy*, ¶553.15, at 553-87 (15th ed. 1995).

A. An Administrative Hold Is Not A Setoff And Does Not Violate Section 362(a)(7).

In the Petitioner's Brief, Citizens explains that a bank's imposition of an administrative hold on a bank account pending determination of the bank's motion for relief from the automatic stay is not an act of setoff as

contemplated by 11 U.S.C. §362(a)(7). *See* Petitioner's Brief at 26-29, 35-36. The starting point for this analysis is a determination of when a setoff occurs. The predominant view, articulated in the oft-cited case of *Baker v. Nat'l City Bank of Cleveland*, 511 F.2d 1016 (6th Cir. 1975), is that an act of setoff is not complete until three steps are taken:

> (1) the decision to exercise the right;
>
> (2) some action which accomplishes the setoff; and
>
> (3) some record which evidences that the right of setoff has been exercised.

Id. at 1018. An administrative hold like the one implemented by Citizens lacks all three of the elements of a setoff. By seeking a bankruptcy court order modifying the stay to permit the setoff, Citizens clearly evidenced an intent to defer exercise of its right of setoff until the bankruptcy court authorized Citizens to act upon the right. The administrative hold alone does not accomplish a setoff, but rather preserves the *status quo* pending bankruptcy court consideration of the matter. *See* Petitioner's Brief at 26-29.

The Respondent's Brief does not address Citizens' explanation that an administrative hold is not a setoff. Instead, Strumpf does nothing other than restate the Fourth Circuit's conclusion and cite to two opinions relied on by the Fourth Circuit, *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), and *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), and one opinion which expressly declined to address the issue of whether a freeze constitutes a setoff, *In re Patterson*, 967 F.2d 505, 513 (11th Cir. 1992) ("This argument raises the issue whether a freeze constitutes a setoff, per se. However, we need not address this issue because the

bankruptcy court based its holding on more than the freeze alone."). *See* Respondent's Brief at 12. Strumpf's argument thus suffers from the same five fundamental mistakes made by the Fourth Circuit below, and is not persuasive. *See* Petitioner's Brief at 31-38.

B. An Administrative Hold Is Not An Act To Exercise Control Over Property Of The Estate And Does Not Violate Section 362(a)(3).

Strumpf readily concedes that the funds he deposited at Citizens were the property of Citizens and not the estate. *See* Respondent's Brief at 13. Nevertheless, Strumpf argues that his right to withdraw money from the account was "at least an equitable right" which became property of the estate upon his bankruptcy filing, and that Citizens' refusal to permit Strumpf to withdraw all of his bank deposits was an act to control property of the estate prohibited by §362(a)(3). *Id.* Strumpf's argument, made without support from any authority, is premised on a false assumption, namely that Strumpf had an absolute right to withdraw the funds on deposit at Citizens at the time Citizens imposed the freeze.

The relationship between a bank and its depositor is contractual. *Carman v. Franklin Bank*, 61 Md. 467, 469 (1884) ("The deposit of money in bank, by one in his own name and in his own right, creates, no doubt, the relation of debtor and creditor—the contract on the part of the bank being to pay the checks of the depositor, so long as it has funds in hand sufficient to do so."). The contractual rights that become the property of the bankruptcy estate are exactly those the depositor had prior to bankruptcy. A bankruptcy filing does not *expand* the debtor's contractual rights: "Though this paragraph

[§541(a)] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 367 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6323; S. Rep. No. 95-989, 95th Cong., 2nd Sess. at 82 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 5868. *Accord* 4 James W. Moore & Lawrence P. King, *Collier on Bankruptcy*, ¶541.01, at 541-7 (15th ed. 1995). A depositor's contractual right to withdraw funds from a bank account is not absolute.

In the instant case, it is undisputed that the parties' contractual relationship granted Citizens a right to set off funds in Strumpf's account to the extent of his debt to the bank. It is further conceded that Strumpf was in default and, prior to the bankruptcy filing, Citizens could have exercised its right of setoff. Strumpf's right to withdraw funds subject to Citizens' setoff right was, therefore, at Citizens' discretion; Strumpf did not have the absolute right to withdraw the funds. Upon Strumpf's bankruptcy filing, this underlying relationship did not change. Citizens' contractual rights were not diminished, and Strumpf's contractual rights did not expand to provide him with an absolute right of withdrawal that did not exist prior to his bankruptcy filing.

As Citizens set forth in the Petitioner's Brief, 11 U.S.C. §542(b) expressly entitles a creditor to retain funds otherwise payable to the debtor to the extent the creditor holds a right of setoff. *See* Petitioner's Brief at 22-24. Strumpf's §362(a)(3) argument has been rejected by several courts which recognized that the language of §542(b) prevails over §362(a)(3), including *In re Williams*, 61 B.R. 567, 573 (Bankr. N.D. Tex. 1986):

> Because Section 542(b) provides that a creditor who has a right of offset does not have to turnover the funds, it unmistakably follows that the person can continue to hold the funds (*i.e.*, an "administrative freeze" or "hold") until an order is entered by a bankruptcy court providing for disposition of the funds in question.

Citizens' exercise of this right thus is not an act to exercise control over Strumpf's right of withdrawal, because Strumpf's right of withdrawal was limited by Citizens' right to retain the funds subject to setoff. A freeze of an account, unlike a setoff, simply maintains the *status quo* and does not violate the automatic stay. *In re Tillery*, 179 B.R. 576, 580 (Bankr. W.D. Ark. 1995).

C. An Administrative Hold Is Not An Act Seeking To Collect Or Recover A Claim And Does Not Violate Section 362(a)(6).

Strumpf also argues that Citizens' administrative hold violated §362(a)(6), which provides that the automatic stay acts as a stay of "any act to collect, assess, or recover a claim against the debtor . . . ." 11 U.S.C. §362(a)(6) (1988). In making this argument, Strumpf relies on two cases, *In re Patterson*, 967 F.2d 505 (11th Cir. 1992), and *In re Figgers*, 121 B.R. 772 (Bankr. S.D. Ohio 1990).[4]

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[4]Strumpf also cites *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), but that case does not even discuss §362(a)(6). As explained in the Petitioner's Brief, *Norton* found that a freeze constituted an act of setoff under the "automatic setoff" doctrine peculiar to Pennsylvania law, and therefore found a violation of §362(a)(7).

Patterson does hold that a credit union's freeze of the debtor's deposit account was a violation of §362(a)(6), but in so holding the Eleventh Circuit mistakenly assumed that the funds in the account were property of the bankruptcy estate, an assumption which even Strumpf acknowledges is wrong. *See Patterson*, 967 F.2d at 511. The Eleventh Circuit also premised its conclusion on the fact that the credit union coupled the administrative freeze with an attempt to coerce the debtors to pay their debt to the credit union. *Id.* at 512.

The court in *In re Figgers* also concluded that the credit union's conduct in that case violated §362(a)(6), but the facts in that case were quite different from the typical bank freeze case like the present one. In *Figgers*, as of the filing of the debtors' bankruptcy petition there was only $39.91 in the debtors' credit union account. The debtors made postbankruptcy deposits in the account, and by the time the credit union imposed a freeze based upon a prebankruptcy loan, it appears that there was $496.49 in the account. The freeze imposed by the credit union covered the entire account. *See Figgers*, 121 B.R. at 774. Consequently, the credit union clearly did violate the automatic stay, because it had no right of setoff against most of the funds it held. Moreover, the court's discussion of the law is not illuminating, as the court does not consider or even mention §542(b), the focal point of the issue before this Court.

Recognition of a depository institution's right under §542(b) to refuse to pay its debt to a bankrupt depositor to the extent of its setoff right, coupled with an understanding that the funds on deposit are the institution's property and not the estate's, should dispel any confusion suffered by the lower courts regarding the

propriety of an administrative hold. As pointed out in the Petitioner's Brief, the Bankruptcy Code's restrictions on a creditor's exercise of a setoff right on the one hand, and on a debtor's ability to obtain a turnover of funds from the creditor on the other hand, creates a purposeful statutory equilibrium which entitles the parties to protect their respective rights by maintaining the *status quo* as of the bankruptcy filing, absent a bankruptcy court order altering this balance. *See* Petitioner's Brief at 24-25. By imposing a freeze on Strumpf's account, Citizens merely exercised its right under §542(b) to decline to pay a debt subject to setoff, to preserve the parties' competing rights to the deposit while the bankruptcy court considered Citizens' motion for relief from the automatic stay. As recognized by other courts, "the administrative freeze is not an attempt to collect a debt, it is an act to maintain the status quo until the rights of the parties can be determined by the bankruptcy court." *Stann v. Mid American Credit Union*, 39 B.R. 246, 248 (D. Kan. 1984) (citing to *In re Edgins*, 36 B.R. 480, 484 (Bankr. 9th Cir. 1984)). *See In re Gifford*, 174 B.R. 231, 233 (Bankr. W.D. Ky. 1994). *Cf. in re Delaware & Hudson Railway Co.*, 127 B.R. 756, 759 (Bankr. D. Del. 1991) (sister railroad's retention of interline funds held in trust for debtor railroad in order to preserve status quo pending judicial determination of setoff did not violate §362(a)(6), also citing to *Edgins*); *In re Briggs*, 143 B.R. 438, 454 (Bankr. E.D. Mich. 1992) (freeze did not violate §362(a)(6) because it did not coerce debtor's voluntary reaffirmation of other unsecured indebtedness).

III.

CITIZENS' RIGHT TO DECLINE TO PAY ITS DEBT SUBJECT TO SETOFF UNDER SECTION 542(b) DOES NOT ARISE, AS STRUMPF ARGUES, ONLY AFTER A COURT HEARING.

Strumpf acknowledges that, "[i]t is true that under the plain language of §542(b), Citizens may decline to turnover debts due by it to the Debtor to the extent Citizens has debts due it from the Debtor . . . ." Respondent's Brief at 17. However, Strumpf argues that a creditor may not exercise this right under §542(b) until after a judicial determination of the creditor's setoff right. *Id.* at 17-19.

For this argument, Strumpf relies on the rationale of the bankruptcy court in the case of *In re Wildcat Constr. Co., Inc.*, 57 B.R. 981 (Bankr. D. Vt. 1986). In that case, the bank did exactly what Strumpf contends Citizens should have done in this case; the bank moved for *ex parte* relief from the automatic stay or for an order prohibiting the debtor from drawing on its checking accounts with the bank. The bankruptcy court denied the bank's motion on the ground that the bank did not need the requested relief because it was already adequately protected by the Code provisions prohibiting the debtor from drawing on the bank's cash collateral without the bank's consent or court authorization. *Id.* at 984-86.[5] The court further noted that the bank failed

[5]Strumpf argues that the restrictions of 11 U.S.C. §363(c)(2) on a debtor's use of cash collateral do not apply to Strumpf because he was not engaged in business. *See* Respondent's Brief at 18-19 n.5. Some lower courts do support Strumpf's argument. However, the language of §363(c)(2) is not restricted to business cases and no other provision of the Code affirmatively authorizes the use of cash collateral. A number of courts therefore have applied §363(c)(2) to nonbusiness debtors. *See, e.g., In re Owens-Peterson*, 39 B.R. 186, 189 (Bankr. N.D. Ga. 1984).

[footnote continued]

to prove that the debtor intended to remove funds from the checking account, and it refused "to presume . . . that most debtors are profligate . . . ." *Id.* at 986-87.

If *Wildcat* is instructive on any point, it is the inadequacy of the Fourth Circuit's approach to the so-called "banker's dilemma". The solution proposed by Strumpf and the Fourth Circuit—to require a bank to file an *ex parte* motion for relief from the automatic stay[6]—offers no assurance that the bank will be able to protect its setoff right despite the express provisions of the Code preserving that right. The bank may not be able to prove that absent a court order the debtor will withdraw funds on deposit, just as the bank was unable to do in *Wildcat*. And the bankruptcy judge's willingness to assume that a debtor will not violate Code provisions restricting the debtor's use of cash, and that an administrative stay is "superfluous", *id.* at 984, provides no comfort to Citizens or other depository institutions. If a depository institution is required to wait until the debtor attempts to withdraw funds, seeking judicial relief at that point would be the quintessential "attempt to lock the barn door after the horse has been stolen." *In re Edgins*, 36 B.R. 480, 484 (Bankr. 9th Cir. 1984). For proof of this point, this Court need look no further than the

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The issue of whether §363(c)(2) applies to a nonbusiness debtor has no bearing on the outcome of the present case. Citizens' right to place an administrative hold on Strumpf's account arose from Citizens' right to refuse to pay a debt subject to setoff under §542(b). Section 363(c)(2) is noteworthy, in any event, because it is perfectly consistent with the statutory equilibrium created by §§542(b), 553, and 362 between the competing rights and interests of debtors and creditors.

[6] *See Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155, 157-58 (4th Cir. 1994), *cert. granted*, ___ U.S. ___, 115 S. Ct. 1398 (1995).

facts of this case. After Citizens was ordered by the bankruptcy court to release its administrative hold, Strumpf withdrew all of the funds on deposit, completely eliminating Citizens' setoff right and the source of payment for Strumpf's debt to the bank. *See* Petitioner's Brief at 5-6.

The problem of reading into the Bankruptcy Code a requirement that a creditor not exercise its right under §542(b) prior to a judicial determination is obvious in the context of a nonbank creditor's dealings with a debtor. As explained in the Petitioner's Brief, a debtor owed money by a creditor may approach the creditor having a right of setoff and demand immediate payment of the creditor's obligation to the debtor. Under Strumpf's argument, the creditor would not be able to decline immediate payment because the creditor was not quick enough to obtain a prior court determination of the creditor's right under §542(b) to refuse to pay the debtor to the extent of the creditor's setoff right. *See* Petitioner's Brief at 44-45. As recognized in a recent case upholding the right of the Internal Revenue Service (the "IRS") to refuse to pay an income tax refund to a Chapter 13 debtor who owed taxes to the IRS:

> Under the analysis of *Strumpf*, the moment a debtor files bankruptcy, any creditor holding funds of the debtor would be in violation of the automatic stay. Under this reasoning, the moment the creditor learns of the bankruptcy, it would be required to turnover the funds in its possession, nullifying the effect of both sections 553 and 542(b) of the Bankruptcy Code.

In re Tillery, 179 B.R. 576, 580 (Bankr. W.D. Ark. 1995).[7]

The injustice of such a result is apparent. So is the fact that a creditor's right under §542(b) to refuse to pay a debt to a bankrupt depositor is not conditioned on a prior court determination. *See* 11 U.S.C. §542(b) (1988).

IV.

STRUMPF'S RECOMMENDATION FOR COURTS TO ADOPT SPECIAL RULES FOR TAXING AUTHORITIES TO AVOID "A PLETHORA OF UNNECESSARY LITIGATION" (1) WILL NOT HELP MOST CREDITORS, AND (2) OFFERS AN INADEQUATE SOLUTION TO A PROBLEM THAT DOES NOT EXIST UNDER A CORRECT READING OF THE BANKRUPTCY CODE.

In Part IV of the Respondent's Brief, Strumpf attempts to address the concerns of the United States with respect to tax refunds and to debtors who owe income taxes to the Government. Under Citizens' view, the right of the United States to refuse to pay income tax refunds to a debtor to the extent of the Government's right of setoff is fully protected under §542(b). According to Strumpf's position, which was adopted by the Fourth Circuit below, the United States would be required to file *ex parte* motions for relief from the automatic stay in countless cases to avoid having to pay money to debtors who owe money to the Government.

Strumpf acknowledges that the United States' concerns are "legitimate", and that the prospect of numerous

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[7] It is noteworthy that the IRS's "freeze" of the debtor's tax refund in *Tillery* occurred after confirmation of the debtor's Chapter 13 plan. The court correctly concluded that confirmation did not alter the express setoff right of the IRS under §553. *Id.* at 578. *See also infra* at 4-6.

ex parte motions for relief from the automatic stay may overburden the bankruptcy courts with a "plethora of unnecessary litigation." *See* Respondent's Brief at 21-22. As a solution for these concerns and expected problems, Strumpf suggests that each of the numerous bankruptcy courts throughout the country adopt special local rules for taxing authorities. This suggestion has serious flaws.

First, relying on scores of bankruptcy courts to adopt their own versions of a rule to allow taxing authorities to exercise setoff rights without filing a motion for relief from the automatic stay is no way to engender a uniform bankruptcy law concerning the exercise of setoff rights in a bankruptcy case. Second, the Maryland local rule referred to by Strumpf is a narrow one. It authorizes the IRS and Maryland taxing authorities to offset against a tax refund owed to a debtor any taxes owed to the taxing authority by the debtor, provided that the taxing authority's claim is undisputed. *See* Rule 25(b), Local Rules of the U.S. Bankruptcy Court for the District of Maryland. Such a rule is of no help where the tax creditor's claim is disputed or the creditor is not a taxing authority. Third and most importantly, the problems addressed by Strumpf's recommendation will not exist under a correct reading of the Code, which properly considers a creditor's right under §542(b) without reading the language of §362(a) in isolation. *See Tillery*, 179 B.R. at 580 ("In *Strumpf*, the Fourth Circuit looked solely to the language of section 362, [and] ignored the provisions of sections 506, 542, 553 . . . .").

The concerns of the United States which Strumpf recognizes as legitimate are concerns of bank and non-bank creditors alike. The Bankruptcy Code properly addresses these concerns through a statutory equilibrium which balances a debtor's interests in obtaining a

turnover of funds with a creditor's interest in preserving its right of setoff. There is no need to weave a patchwork of local rules to fill a hole that exists only by virtue of Strumpf's argument.

CONCLUSION

For these reasons, and those stated in the Petitioner's Brief, the decision of the Fourth Circuit should be reversed and the case remanded for entry of the original Order issued by the district court.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND, PETITIONER

v.

DAVID STRUMPF

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether the creditor of a debtor in bankruptcy may withhold payment of a debt it owes to the debtor while the creditor seeks relief from the automatic stay to exercise its setoff rights.

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INTEREST OF THE UNITED STATES

This case concerns whether, during the period that the creditor in a bankruptcy case is seeking relief from the automatic stay to exercise its setoff rights, the creditor may withhold payment of a debt owed to the debtor. This issue is of substantial importance to the United States, whose agencies and instrumentalities are often creditors under federal programs involving loans, loan guarantees, contracts, assistance and benefit payments and tax collection activities. Indeed, two of the decisions upon which the court of appeals relied in the present case involved holdings that the United States violated the automatic stay by withholding a refund of overpaid taxes for one tax

year even though the debtor had a larger outstanding tax liability for a different year. Pet. App. 9, 10, citing *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985); *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983). A third decision relied on by the court of appeals involved efforts of the Small Business Administration to offset its loan claim against crop payments due the debtor from the Department of Agriculture. Pet. App. 7, citing *Small Business Administration* v. *Rinehart*, 887 F.2d 165 (8th Cir. 1989).

The lower courts have reached a variety of conflicting results in addressing this recurring issue. As a result, federal agencies face disparate treatment of identical claims arising under national programs. The United States therefore has a substantial interest in the resolution of this recurring conflict.

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Bankruptcy Code are reprinted in the appendix to this brief.

STATEMENT

1. Petitioner is a bank conducting business in the State of Maryland. In 1989, petitioner loaned respondent approximately $5000. That loan was in default before respondent filed a petition for relief in bankruptcy under Chapter 13 in January 1991 (Pet. App. 3). Under Section 362 of the Bankruptcy Code, the filing of the petition in bankruptcy gave rise to an "automatic stay" of various types of activity by respondent's creditors. In particular, the filing stayed "the setoff of any debt owing to the debtor

that arose before the commencement of the [bankruptcy] case." 11 U.S.C. 362(a)(7).

In October 1991, the bank moved for relief from the automatic stay in order to set off approximately $3200 then in respondent's checking account against the remaining balance that respondent owed on the loan. While the motion for relief from the stay was pending, the bank placed an "administrative hold" on the balance of approximately $3500 in respondent's checking account. During the period of the hold, petitioner temporarily refused to pay withdrawals that respondent sought to make from the account. Respondent reacted to the bank's "administrative hold" by filing a motion in bankruptcy court seeking to have the bank held in contempt of the automatic stay (Pet. App. 4).

The bankruptcy court ruled on debtor's contempt motion before addressing the bank's prior motion for relief from the automatic stay. The court concluded that the bank's "administrative hold" on respondent's account represented a "setoff" in violation of the automatic stay and, as a sanction for violation of the stay, ordered the bank to pay actual and punitive damages and attorneys' fees to respondent (Pet. App. 34-36). At that time, the court reserved its ruling on the bank's motion for relief from the stay.

Nineteen days later, the bankruptcy court granted the bank's motion for relief from the stay and authorized the bank to set off respondent's remaining account balance against the unpaid loan. By that time, however, there was nothing left to set off because respondent had withdrawn all of his funds from the bank (Pet. App. 4-5).

2. The district court reversed the judgment holding the bank in violation of the automatic stay. The

court concluded that the bank's temporary freeze of respondent's account during the period that the bank sought relief from the automatic stay was not a violation of the statute (Pet. App. 18-33).

3. The court of appeals reversed and reinstated the bankruptcy court judgment (Pet. App. 1-17). The court held that a creditor's administrative freeze of amounts subject to setoff is "tantamount" (*id.* at 9) to the exercise of the right of setoff and therefore violates 11 U.S.C. 362(a)(7). The court reasoned that its holding was compelled by "the clear and unambiguous language" of the statute, which prohibits any "setoff" during the automatic stay (Pet. App. 13-14). The court further stated that the bank's actions in freezing a debtor's accounts could substantially diminish the debtor's chances for successful rehabilitation (*id.* at 14-15). Concluding that the automatic stay had been violated by the bank, the court ordered reinstatement of the award of actual and punitive damages and attorneys' fees to respondent (*id.* at 15-16).

SUMMARY OF ARGUMENT

Section 553 of the Bankruptcy Code recognizes the defense of setoff in bankruptcy cases and Section 542(b) of the Code provides that a creditor is not required to "pay" a claim of the estate to the extent that such a claim "may be offset" (11 U.S.C. 542(b)). A creditor, such as petitioner, is not acting in violation of the automatic stay by temporarily declining to pay the debtor funds that the Bankruptcy Code expressly provides need not be paid at all.

The automatic stay of a "setoff" under Section 362(a)(7) of the Bankruptcy Code does not apply

to the creditor's temporary maintenance of the status quo while application is made to the court for a judicial determination whether a "setoff" *may* properly be made. The term "setoff" in the stay provision of Section 362(a)(7) was necessarily employed by Congress in a manner conformable with ordinary usage—to mean the formal exercise of a right of setoff through an overt act that purports to extinguish, pro tanto, the opposing claim. The completed "setoff" to which Section 362(a)(7) refers necessarily involves far more than the creditor's temporary refusal to pay a claim and the creditor's submission of that claim for adjudication under the procedures specifically provided for this purpose by Sections 362(d) and 542(b) of the Bankruptcy Code.

ARGUMENT

THE REFUSAL OF A CREDITOR TO PAY A DEBT OWED TO THE BANKRUPTCY ESTATE IS NOT A "SETOFF" THAT VIOLATES THE AUTOMATIC STAY OF SECTION 362(a)(7) OF THE BANKRUPTCY CODE

Section 362(a)(7) of the Bankruptcy Code provides an automatic stay of "the setoff" of any prepetition debt of the debtor by any creditor. 11 U.S.C. 362(a)(7). The court of appeals erred in this case in concluding that a "setoff" occurs when a creditor maintains the status quo by not paying a claim of the debtor in order to assert a defense to that claim. Sections 542(b) and 553 of the Bankruptcy Code expressly protect a creditor from the obligation to pay amounts owed to the debtor to the extent that the creditor possesses a right of setoff. A creditor, such as petitioner, is not acting in violation of the automatic stay by temporarily declining to pay the debtor

funds that the Bankruptcy Code expressly provides need *not* be paid.

1. a. As this Court stated in *Bank of Marin* v. *England*, 385 U.S. 99 (1966), the relationship of a bank and its depositor "is that of debtor and creditor" and is "founded upon contract" (*id.* at 101). A bankruptcy estate that seeks to enforce such a contractual relationship "is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition." *Ibid.* One of the defenses that a bank or other creditor may assert to a claim of the bankruptcy estate is the defense of setoff. 11 U.S.C. 553(a).

It is not a violation of the automatic stay for an entity to refuse to pay a disputed debt that the bankruptcy estate asserts is owed to it.[1] Neither the Bankruptcy Code in general nor the automatic stay provisions in particular require entities against whom the bankruptcy estate asserts a claim simply to succumb to the estate's claims. The automatic stay bars various affirmative actions by the creditors of the estate

[1] The automatic stay lists several types of actions that, upon the filing of the bankruptcy case, creditors are restrained from taking. The stay restrains "all entities" from (i) commencing or continuing judicial or administrative proceedings against the debtor, (ii) enforcing judgments against the debtor, (iii) obtaining possession of, or exercising control over, property of the debtor's estate, (iv) taking action to create or enforce a lien in property of the debtor's estate, (v) taking action to create or enforce a lien in the debtor's property to secure a claim that arose before the bankruptcy case was commenced, (vi) taking action to collect a claim against the debtor, (vii) setting off any debt owing to the debtor that arose before the commencement of the case against any claim of the debtor and (viii) commencing or continuing a proceeding concerning the debtor in the United States Tax Court. 11 U.S.C. 362(a)(1)-(8).

(see note 1, *supra*), but it does not require entities against whom the estate has asserted a claim to waive all defenses that they may have to the claim and immediately pay it. As the court of appeals stated in *United States* v. *Inslaw, Inc.*, 932 F.2d 1467, 1473 (D.C. Cir. 1991), cert. denied, 502 U.S. 1048 (1992),[2]

> [t]he object of the automatic stay provision is * * * to make sure that creditors do not destroy the bankrupt estate in their scramble for relief. * * * Fulfillment of that purpose cannot require that every party who acts in resistance to the debtor's view of its rights violates [the automatic stay].

The refusal of petitioner to pay the debt claimed by the bankruptcy estate in this case, and its decision to seek an adjudication of its claimed defense of "setoff," do not violate the automatic stay.

When, as occurred in this case, the bankruptcy estate believes that an entity has improperly refused to pay a debt owed to the estate, the estate is to apply to the bankruptcy court for a "turnover" order under Section 542 of the Bankruptcy Code. Under Section 542, when "an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order" has refused to pay that debt to the estate, the bankruptcy court may

[2] In *Inslaw*, the court rejected the assertion of the bankruptcy estate that a failure of an entity to agree with the debtor's assertion of its rights in particular property represents an "exercise [of] control over property of the estate" (11 U.S.C. 362(a)(3)) within the meaning of the automatic stay provision. See 932 F.2d at 1473.

order that entity (11 U.S.C. 542(b) (emphasis added))

> [to] pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.*

The "turnover" provision thus expressly incorporates the defense of setoff under Section 553. Section 553, in turn, provides that every creditor has the right "to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the [bankruptcy] case * * * against a claim of such creditor against the debtor that arose before the commencement of the case." 11 U.S.C. 553(a).

Under these provisions, when petitioner declined to pay the debt claimed by the estate—a debt represented by the bank account balance—the estate's remedy was to apply for a "turnover" order under Section 542.[3] In such "turnover" proceedings, petitioner would have been entitled to assert its defense of setoff under Section 553 and the bankruptcy court would have been required to recognize that defense under Section 542(b).

[3] If the claim that the bankruptcy estate asserts is disputed as to either its validity or its amount, adjudication of that claim would not fall within the core jurisdiction of the bankruptcy court. See, *e.g.*, *United States* v. *Inslaw, Inc.*, 932 F.2d at 1472 ("the debtor cannot use the turnover provisions to liquidate contract disputes or otherwise demand assets whose title is in dispute"); *In re Charter Co.*, 913 F.2d 1575, 1579 (11th Cir. 1990). As the court stated in *Inslaw*, "Congress may not vest in a non-Article III (bankruptcy) court the power to adjudicate a traditional contract action where the defendant is before the court 'only because the plaintiff has previously filed a petition for reorganization in that court.'" 932 F.2d at 1472, quoting *Northern Pipeline Construction Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50, 90 (1982) (Rehnquist, J., concurring in the judgment). In this case, the claim of the bankruptcy estate was not disputed and the claim of setoff was recognized to be valid by the bankruptcy court (Pet. App. 4). In this context, the "turnover" order procedure of Section 542(b) would have been applicable and should have resulted in an order that petitioner "turn over" only the portion of the account, if any, that exceeded the amount of the creditor's setoff rights against the estate.

b. The Bankruptcy Code recognizes two specific restrictions on the statutory right of setoff under Section 553: (i) the creditor may be required in a "turnover" proceeding, notwithstanding its right of setoff, to pay the amount of the debt claimed by the estate if the estate provides "adequate protection" for the creditor's setoff right through some other means (11 U.S.C. 553(a), incorporating 11 U.S.C. 363(e));[4] and (ii) the creditor may not, indepen-

[4] The bankruptcy estate may demand payment of a matured debt that is subject to a creditor's right of setoff in order to "use" the proceeds of the debt to operate the business. *In re Edgins*, 36 B.R. 480, 483 (Bankr. 9th Cir. 1984). Since the proceeds of that debt are security for the creditor's claim (11 U.S.C. 506(a)) and are considered "cash collateral" (11 U.S.C. 363(a)), the creditor may demand "adequate protection" of its interest as a condition of payment (11 U.S.C. 363(e)). See 2 *Collier on Bankruptcy* ¶ 363.02, at 363-16 (15th ed. 1995). See also *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 202-204 (1983). The creditor may be forced to pay the debt and forgo its setoff rights only if the trustee or debtor can furnish an alternative "adequate protection" for the setoff right. 11 U.S.C. 363(e). If the estate cannot provide adequate protection for the setoff right, the court cannot force payment to the estate. See *ibid.*; *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994).

dently of these Bankruptcy Code procedures, set off its claim against the debtor's claim without obtaining an order from the court lifting the automatic stay against such a "setoff" (11 U.S.C. 553(a), incorporating 11 U.S.C. 362(a)(7)). Subject only to those two restrictions, the creditor's right of setoff is fully preserved in bankruptcy. *In re Corland Corp.*, 967 F.2d 1069, 1076 (5th Cir. 1992); *In re Patterson*, 967 F.2d 505, 508 (11th Cir. 1992); H.R. Rep. No. 595, 95th Cong., 1st Sess. 377 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 91 (1978).

In particular, Section 542(b) specifies that a creditor who owes a debt to the debtor is not required to "pay" that debt to the extent that the creditor's claim may be set off against it. 11 U.S.C. 542(b).[5] A creditor such as petitioner cannot logically be said to be acting in contempt of the automatic stay when it temporarily declines to pay the debtor funds that Section 542(b) of the Bankruptcy Code expressly provides need not be paid at all.

2. The court of appeals nonetheless concluded that even a temporary refusal to pay the estate's claim

[5] Section 506(a) of the Code provides further protection for the right of setoff by specifying that a creditor's claim of "setoff" against the debtor "is a secured claim." 11 U.S.C. 506(a). As a "secured claim," the right of setoff is not subject to discharge merely to enhance the debtor's opportunity for rehabilitation. See *Dewsnup* v. *Timm*, 502 U.S. 410, 418 (1992); *Johnson* v. *Home State Bank*, 501 U.S. 78, 84 (1991). "[W]hile reorganization of the debtor is an important policy goal, this goal cannot be pursued by exterminating a secured creditor's property interest. 'Reorganization is not a Holy Grail to be pursued at any length.'" *In re Rash*, 31 F.3d 325, 330 (5th Cir. 1994). See also *In re Simmons*, 765 F.2d 547 (5th Cir. 1985).

is "tantamount" to a "setoff" and is therefore barred by the automatic stay of Section 362(a)(7) (Pet. App. 9, 13-14). That conclusion would deprive the provisions of the Code that protect the creditor's defense of "setoff" of all plausible meaning.

Under the reasoning applied by the court of appeals in this case, an entity that owes a debt to the estate may not protect its right of setoff by simply refusing to pay the estate's claim and submitting its rights to adjudication in an orderly fashion. Instead, under the threat of statutory sanctions (11 U.S.C. 362(h)), the creditor must immediately pay funds demanded by the debtor and thereby relinquish its right of setoff (Pet. App. 7) ("the debtor may defeat the creditor's right of setoff by removing all funds in the creditor's possession before the creditor can obtain relief from the stay"). The facts of this case reveal that this concern is not merely theoretical: between (i) the time that the bankruptcy court entered its order finding the bank in contempt for refusing to pay the withdrawals requested by the estate and (ii) the court's subsequent order finding the bank to be entitled to set off its claim against that account, the debtor withdrew the entire account balance (Pet. App. 4-5).

The court's conclusion that the creditor must bow to the debtor's demand for payment eviscerates the provisions of the Code that purport to protect the defense of "setoff" and that specify that a creditor is *not* required to "pay" a claim subject to setoff. 11 U.S.C. 542(b). The decision of the court of appeals in this case thus fails to honor this Court's admonition that the meaning of a statute should be discerned from a reading "of the whole statute, not

of isolated sentences." *Beecham* v. *United States*, 114 S. Ct. 1669, 1671 (1994); see *United Savings Ass'n of Texas* v. *Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988) (interpretation of Bankruptcy Code "is a holistic endeavor"). In particular, the court of appeals erred by disregarding the "elementary canon of construction that a statute should be interpreted so as not to render one part inoperative." *Department of Revenue of Oregon* v. *ACF Industries, Inc.*, 114 S. Ct. 843, 848 (1994), quoting *Mountain States Telephone & Telegraph Co.* v. *Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

The decision of the court of appeals would convert the provisions of the automatic stay from a shield—that protects the estate against certain affirmative acts of the creditors of the estate—into a sword—that requires other parties to pay claims of the estate without delay and without opportunity for adjudication of the defenses they may have to the estate's claim. It is ironic that, under the court's reasoning, (i) an entity that possesses a right of setoff (a right explicitly recognized in the Bankruptcy Code itself) may be found to violate the automatic stay by refusing immediately to pay a claim of the bankruptcy estate but (ii) an entity that refuses to pay a claim of the estate based upon any *other* defense to that claim could *not* be found to have violated the stay. See *United States* v. *Inslaw, Inc.*, 932 F.2d at 1473.

The automatic stay of a "setoff" under Section 362(a)(7) of the Bankruptcy Code is not designed to defeat the ultimate right of setoff. Instead, its purpose is to ensure a provisional state of equilibrium. It stays formal implementation of a setoff pending an "orderly examination of the debtor's and creditor's rights." *In re Corland Corp.*, 967 F.2d at 1076. A creditor may initiate such an "orderly examination" by asking the court for relief from the stay. See 11 U.S.C. 362(d).[6] The bankruptcy estate also may initiate an examination of the creditor's setoff rights by applying for an order requiring the "turnover" of the disputed funds under Section 542(b).

If it is determined in such proceedings that the creditor has a valid right of setoff, the creditor is not required to pay the debt to the estate to the extent of the setoff. 11 U.S.C. 542(b). Only to the extent that the creditor's debt to the debtor exceeds the creditor's setoff rights against the debtor is the creditor required to "pay such debt to, or on the order of, the trustee" (*ibid.*).[7]

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[6] A creditor who violates the stay by setting off the mutual debts without first obtaining relief from the stay may be liable for damages and attorneys' fees to any individual injured by the violation. 11 U.S.C. 362(h). Under recent amendments to the Bankruptcy Code, the United States may also be liable for damages for a violation of the automatic stay. 11 U.S.C. 106(a), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 113, 108 Stat. 4117.

[7] When the creditor's claim may be offset against a larger debt to the debtor, the claim is oversecured. See 11 U.S.C. 506(a). In calculating the creditor's claim, the creditor is entitled to add post-petition "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." 11 U.S.C. 506(b); see *Rake* v. *Wade*, 113 S. Ct. 2187, 2191-2192 (1993); *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989). The entire amount of the principal, interest, fees and other

3. In concluding that a creditor violates the automatic stay against a "setoff" by temporarily declining the debtor's request for payment, the court of appeals gave little heed to these carefully designed, interlocking statutory provisions. Instead, the court relied (Pet. App. 9-10) on its earlier decision in *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985), which in turn had relied on the reasoning of the Third Circuit in *United States* v. *Norton*, 717 F.2d 767 (1983). In *Norton*, which involved the government's temporary refusal to pay a refund of a tax overpayment for one year when a larger federal tax deficiency existed for a different year, the Third Circuit noted that the Bankruptcy Code neither defines the term "setoff" nor explains when a "setoff" occurs for purposes of the automatic stay. 717 F.2d at 772. The court concluded that nonbankruptcy law should govern and looked to Pennsylvania law—rather than to federal internal revenue law—to determine when a "setoff" of federal tax liabilities occurs. *Ibid.* Purporting to apply Pennsylvania law, the court stated in *Norton* that "retention of a debtor's funds by a creditor provides sufficient evidence of an intent to setoff" the mutual debts. *Ibid.*, citing *Pittsburgh National Bank* v. *United States*, 657 F.2d 36 (3d Cir. 1981).[8] Invoking the analysis

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charges may then be set off against the claim of the estate. *In re Rozel Industries, Inc.*, 120 B.R. 944, 953 (Bankr. N.D. Ill. 1990).

[8] Pennsylvania applies a rule of "automatic setoff," under which a setoff is said to occur as a matter of law at the moment that the creditor's claim matures. See *Pittsburgh National Bank* v. *United States*, 657 F.2d 36, 38 (3d Cir. 1981). Even if Pennsylvania law were the appropriate law governing the setoff of federal tax overpayments in bankruptcy (which we dispute), the Third Circuit's rationale in *Norton* would be incorrect. Under the "automatic setoff" doctrine of Pennsylvania, it is the maturation of a debt that, by operation of law, causes the debt "automatically" to be set off. See 657 F.2d at 38. If that reasoning were applied to a case involving taxes, a setoff could be said to occur "automatically" the instant that a tax overpayment was received. If the overpayment were received before bankruptcy, the setoff would be a *fait accompli* before the automatic stay ever arose and there would have been no stay violation. If, on the other hand, the overpayment were received after the bankruptcy petition was filed, the automatic stay would intervene to prevent the setoff from occurring "automatically" under state law. The state automatic setoff would be stayed by the federal automatic stay. No violation of the stay against setoffs could occur, at least not by operation of Pennsylvania's automatic setoff doctrine, upon which the Third Circuit purported to rely in *Norton*.

of *Norton* in *Reynolds*, the Fourth Circuit stated that it could not find any state or federal law as to when a "setoff" occurs with respect to tax overpayments. The court nonetheless elected to apply what it regarded as the "broader rationale" of *Norton* (764 F.2d at 1007, quoting 717 F.2d at 773):

> If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished.

There are two significant defects in the reasoning applied by the Fourth Circuit in *Reynolds* and in the present case.

(i) If, as the court assumes, the term "setoff" in the Bankruptcy Code is to be defined by resort to non-Code law, the general rule is that a setoff requires (i) a decision to effectuate a setoff, (ii) an

overt act accomplishing the setoff and (iii) a record of the setoff. See, *e.g.*, *Horton Dairy, Inc.* v. *United States*, 986 F.2d 286, 291 (8th Cir. 1993); *United States* v. *Bell Credit Union*, 860 F.2d 365, 369 (10th Cir. 1988); *United States* v. *Central Bank of Denver*, 843 F.2d 1300, 1309-1310 (10th Cir. 1988); *In re Saugus General Hospital, Inc.*, 698 F.2d 42, 47 (1st Cir. 1983); *Citizens & Peoples National Bank of Pensacola* v. *United States*, 570 F.2d 1279, 1283-1284 (5th Cir. 1978); *United States* v. *Citizens & Southern National Bank*, 538 F.2d 1101, 1107 (5th Cir. 1976), cert. denied, 430 U.S. 945 (1977); *Baker* v. *National City Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975); *Michigan Carpenters' Council Pension Fund* v. *Smith & Andrews Construction Co.*, 681 F. Supp. 1252, 1254 (E.D. Mich. 1988); *Baltimore & Associates, Inc.* v. *Municipal Escrow & Title Co.*, 625 F. Supp. 1271, 1272-1273 (D.D.C. 1985); *In re Archer*, 34 B.R. 28, 29 (Bankr. N.D. Tex. 1983); *Normand Josef Enterprises, Inc.* v. *Connecticut National Bank*, 646 A.2d 1289, 1299 (Conn. 1994); *Ferguson Enterprises, Inc.* v. *Main Supply, Inc.*, 868 S.W.2d 98, 100 (Ct. App. 1993), review denied, No. 92-CA-0884-MR (Ky. Feb. 16, 1994); *United Seeds, Inc.* v. *Eagle Green Corp.*, 389 N.W.2d 571, 574 (Neb. 1986); *Hill* v. *Mercantile First National Bank of Doniphan*, 693 S.W.2d 285, 291-292 (Mo. Ct. App. 1985); *Aspen Industries, Inc.* v. *Marine Midland Bank*, 426 N.Y.S.2d 620, 622 (App. Div. 1980), rev'd on other grounds, 439 N.Y.S.2d 316 (1981). But see note 8, *supra*. See also Paul S. Groschadl, *"Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?*, 57 Am. Bankr. L.J. 75, 76 (1983). That general rule—rather than the exceptional Pennsylvania rule relied on in *Norton*—appears applicable in Maryland, where the dispute in the present case

arose. See *Barrier* v. *Marine Midland Trust Co.*, 284 A.2d 418, 424 (Md. 1971).[9]

(ii) More fundamentally, the court's suggestion that nonbankruptcy law should determine whether a "setoff" has occurred for purposes of Section 362 (a)(7) of the Bankruptcy Code cannot be reconciled with the other applicable provisions of that Code.[10]

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[9] Federal statutes governing the government's setoff rights similarly contemplate the taking of affirmative steps to execute a setoff. See 26 U.S.C. 6402(a) ("In the case of any overpayment, the Secretary * * * may credit the amount of such overpayment * * * against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall * * * refund any balance to such person."); 31 U.S.C. 3716(a) ("The head of the agency may collect by administrative offset."); 31 U.S.C. 3728 ("The Comptroller General shall withhold paying that part of a judgment against the United States Government presented to the Comptroller General that is equal to a debt the plaintiff owes the Government [and] * * * shall * * * discharge the debt if the plaintiff agrees to the setoff * * * or * * * have a civil action brought [to establish the Government's claim].").

[10] Although a creditor's right of setoff is conferred by nonbankruptcy law, bankruptcy law governs the manner of its enforcement in bankruptcy cases. See *Studley* v. *Boylston National Bank*, 229 U.S. 523, 528 (1913). In fashioning a rule concerning how a setoff is to be executed in bankruptcy cases, courts should avoid state and other nonbankruptcy law that "would frustrate specific objectives of the federal programs" (*Kamen* v. *Kemper Financial Services, Inc.*, 500 U.S. 90, 98 (1991), quoting *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979)). See *United States* v. *Little Lake Misere Land Co.*, 412 U.S. 580, 596 (1973). When the language of the bankruptcy statute indicates that a uniform federal rule is intended to govern enforcement of rights that arise under nonbankruptcy substantive law, this Court has not hesitated to adopt a uniform federal rule. See *Chicago Board of Trade*

Under Section 542(b), a creditor in bankruptcy is *not* required to "pay" a claim to which the defense of setoff applies. 11 U.S.C. 542(b). Congress could not have intended the temporary refusal to pay such a claim—and the application for a judicial determination of whether a "setoff" *may* be made—to itself represent a "setoff" in violation of the automatic stay. Instead, the term "setoff" in the stay provision of Section 362(a)(7) was necessarily employed by Congress in a manner conformable with ordinary usage—to mean the formal exercise of a right of setoff through an overt act that purports to extinguish, pro tanto, the opposing claim.[11] The completed "setoff" to which Section 362(a)(7) refers necessarily involves far more than the temporary refusal to pay a claim.

The construction of the term "setoff" adopted by the court of appeals in this case—that a creditor's

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v. *Johnson*, 264 U.S. 1, 10 (1924) (a federal definition of the term "property" is appropriate "when the language of Congress indicates a policy requiring a broader construction of the [term] than the state decisions would give it").

[11] As this Court stated in an analogous context under the bankruptcy practice that preceded enactment of the Bankruptcy Code, a "setoff" in a bankruptcy case "is [not] automatically made between parties holding mutual credits" and "is not self-executing" (*Cumberland Glass Manufacturing Co.* v. *DeWitt & Co.*, 237 U.S. 447, 457 (1915)). The administrative freeze at issue in this case is nothing more than a refusal to pay communicated to the bank's various branches and automated teller machines. The fact that the freeze must be communicated internally and effected on an institution-wide basis does not make the bank's refusal to pay any more objectionable under the automatic stay. It is not the purpose of the automatic stay to frustrate nonbankruptcy setoff rights by preventing internal creditor communications. See *In re Farmers Markets, Inc.*, 792 F.2d 1400, 1404 (9th Cir. 1986).

refusal to honor a debtor's demand for payment is "tantamount to the exercise of a right of setoff" (Pet. App. 9)—would directly nullify the complex statutory framework that protects and preserves the right of setoff. In particular, it would nullify the express statement in Section 542(b) that the creditor may refuse to "pay" a debt that is subject to setoff. By failing to recognize that the Bankruptcy Code protects the ultimate implementation of the creditor's right of setoff, the court of appeals erred in holding that a temporary refusal to pay is barred by Section 362(a)(7).

4. a. A creditor's temporary refusal to pay the claim of the debtor's estate also would not violate other aspects of the automatic stay. In *In re Patterson*, 967 F.2d at 511, the court of appeals concluded that a temporary "freeze" on the debtors' account with a credit union would violate Section 362(a)(3) of the Bankruptcy Code. That Section stays "any act * * * to exercise control over property of the estate." 11 U.S.C. 362(a)(3).[12] The court reasoned that a

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[12] In *Patterson*, the court of appeals found it unnecessary to determine whether the refusal of a bank to pay an account claimed by the debtor would represent an exercise of a "setoff" in violation of Section 362(a)(7). The court stated that, even if "we assume that a freeze is not a setoff" (967 F.2d at 509), the credit union's freeze on the debtors' account represented an "exercise [of] control over property of the estate" within the scope of the automatic stay under Section 362(a)(3). 967 F.2d at 511-512.

The court further stated, however, that, "[a]lthough we do not address here the issue of whether a freeze constitutes a setoff, per se, our opinion eviscerates the logic of those opinions which answer this question in the negative." 967 F.2d at 513. In making this assertion, the court was referring to the portion of its opinion that stated, without citation

"freeze" of the debtors' account by the credit union represented an "exercise [of] control over property of the estate" because "[t]he funds in the [debtors'] accounts became property of the estate when the [debtors] filed for bankruptcy." 967 F.2d at 511.

The analysis of the court of appeals in *Patterson* is fundamentally flawed. As this Court has noted on several occasions, a bank does not hold a discrete set of funds that belong to the depositor; instead, the bank owes its depositor a contract debt. *Barnhill* v. *Johnson*, 112 S. Ct. 1386, 1389 (1992); *Bank of Marin* v. *England*, 385 U.S. at 101. When the depositor files for bankruptcy relief, it is his contract claim against the bank—not any specified fund or set of dollar bills—that becomes property of the estate.

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of authority, that a creditor entitled to a setoff should protect its rights not by freezing the debtor's account but by filing "an ex parte motion" for relief from the stay and "accompany this motion with the funds from the debtor's account to be paid into the registry of the bankruptcy court." *Id.* at 511. In recommending that course of action, the court of appeals gave no consideration to the common meaning of the term "setoff" that Congress employed in Section 362(a)(7) (see pages 15-16, *supra*) or to the fact that the "turnover" procedures of Section 542 contemplate that the debtor, as well as the creditor, may place the matter at issue in the bankruptcy court (see pages 7-9, *supra*). There is little doubt that a creditor *could* follow the procedure recommended by the court in *Patterson*, and it also may be that a bankruptcy court could order temporary payment of the disputed account into the court's registry in a particular case. But there is nothing to indicate that Congress intended to require those procedures to be followed at the risk of contempt upon default. No other account debtor of the estate would be subject to contempt for refusal to pay a disputed claim of the estate.

Bank of Marin v. *England*, 385 U.S. at 101.[13] A refusal to pay sums that the estate claims are owed to it on a contract debt is not an exercise of control over "property of the estate." It is, instead, the assertion of a defense to the debtor's claim—a defense that Sections 553 and 542(b) specifically authorize. The bankruptcy estate steps into the shoes of the debtor and therefore necessarily has taken its claim to the account "subject" to that defense (*Bank of Marin* v. *England*, 385 U.S. at 101).

As the court of appeals explained in *United States* v. *Inslaw, Inc.*, 932 F.2d at 1473, it is not a violation of the automatic stay of Section 362(a)(3) "whenever someone already in possession of property * * * refuses to capitulate to a bankrupt's assertion of rights in that property." A creditor who is entitled to protect its right of setoff under Sections 542 and 553 of the Bankruptcy Code need not abandon that right to avoid a violation of the automatic stay under Section 362. *In re Corland Corp.*, 967 F.2d at 1077.[14]

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[13] Similarly, when a debtor has made an "overpayment" of federal taxes for which a refund is available under the Internal Revenue Code, the debtor is not entitled to any specific set of funds located in the Treasury. *United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 38-39 (1992). The "property" of the debtor in that situation is his statutory cause of action for a refund. That statutory cause of action is itself, however, subject to a statutory right of setoff. See 26 U.S.C. 6402(a). If the bankruptcy estate were to bring a "turnover" action to collect the refund in bankruptcy court, the United States would not be required to pay the refund to the extent that it possesses a right of setoff. 11 U.S.C. 542(b).

[14] Cf. *In re Davis*, 889 F.2d 658 (5th Cir. 1989) (court is not to sanction creditor under Section 502(d) of the Bankruptcy Code for refusing to pay debt to estate pending resolu-

b. A temporary refusal to pay a debt owed to the bankruptcy estate also does not violate the automatic stay of Section 362(a)(6), which proscribes "any act to collect [a prepetition debt]." 11 U.S.C. 362 (a)(6). Temporarily preserving the status quo pending a determination of the creditor's setoff right by the bankruptcy court does not represent an unauthorized "act to collect"; if it did, the provisions of Section 542(b) that specify that a debt subject to setoff need not be paid would be nullified. See 11 U.S.C. 542(b). "For obvious reasons, * * * courts have recognized that § 362(a) cannot stay actions specifically authorized elsewhere in the bankruptcy code" (*United States* v. *Inslaw, Inc.*, 932 F.2d at 1474).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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tion of creditor's right to setoff), cert. denied, 495 U.S. 933 (1990).

APPENDIX

1. 11 U.S.C. 362 (1988) provides in relevant part:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—

* * * * *

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; * * *

* * * * *

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

* * * * *

(h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

2. 11 U.S.C. 363 (1988) provides in relevant part:

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

* * * * *

(c)(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

* * * * *

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the

court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

* * * * *

3. 11 U.S.C. 506(a) provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

4. 11 U.S.C. 542(b) provides:

Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

5. 11 U.S.C. 553(a) provides in relevant part:

Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does

not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case * * *.

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No. 94-1340

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

vs.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, AMERICAN BANKERS ASSOCIATION, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, NATIONSBANK, N.A., NATIONSBANK, N.A. (CAROLINAS), THE FIRST NATIONAL BANK OF MARYLAND, FIRST FIDELITY BANK, N.A. AND CREDIT UNION NATIONAL ASSOCIATION, INC., *AMICI CURIAE*, SUPPORTING REVERSAL

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Question Presented

Does a depository institution violate the Bankruptcy Code's automatic stay under 11 U.S.C. § 362(a) when it imposes an administrative freeze to maintain its right of setoff preserved and recognized under 11 U.S.C. §§ 542(b), 553(a), 506(a), 362(d) and 363(e)?

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IN THE

Supreme Court of the United States

October Term, 1994

No. 94-1340

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, AMERICAN BANKERS ASSOCIATION, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, NATIONSBANK, N.A., NATIONSBANK, N.A. (CAROLINAS), THE FIRST NATIONAL BANK OF MARYLAND, FIRST FIDELITY BANK, N.A. AND CREDIT UNION NATIONAL ASSOCIATION, INC., *AMICI CURIAE*, SUPPORTING REVERSAL

This brief is in support of reversal and is filed pursuant to Rule 37.3 with the consent of all parties.

Interest of *Amici Curiae*

The New York Clearing House Association is an association of 11 leading commercial banks in the City of New York; with more than $352 billion in domestic loans outstanding, its member banks are among the nation's largest

consumer and commercial lenders. The American Bankers Association is a trade association for the banking industry, representing banks located in each of the 50 states and the District of Columbia, including national and state-chartered banks of all sizes; the combined assets of its member banks total some 90 percent of all banking assets in the United States. The Independent Bankers Association of America is a nonprofit national trade association that represents the interests of the nation's community banks; its nearly 6,000 national and state-chartered member banks are located in all 50 states and the District of Columbia. Credit Union National Association, Inc. is the national trade association for credit unions, representing the interests of approximately 90 percent of the more than 12,500 federal and state-chartered credit unions operating in the United States with approximately 67,000,000 consumer members. NationsBank, N.A., NationsBank, N.A. (Carolinas), The First National Bank of Maryland and First Fidelity Bank, N.A. also join in this brief.

The issue presented by this case is of the utmost commercial significance to banks and other depository institutions. The Bankruptcy Code[1] makes explicit and detailed provision for preservation of setoff rights, which are fundamental to lending practices and procedures. The rule adopted by the court below, by contrast, would require depository institutions to relinquish their long-established right of setoff in the event of a borrower's bankruptcy, and thus sharply increase the losses that depository institutions suffer as a result of borrower defaults. Depository institutions will be forced to respond by charging higher interest rates, requiring additional collateral or guaranties or, in some cases, refusing to extend credit. Moreover, the rule adopted by the court below injures depository institutions that forbear from

[1] 11 U.S.C. §§ 101 et seq. References to "Section" or "§" are to the Bankruptcy Code (the "Code").

exercising setoff rights prepetition, and will precipitate bankruptcy filings by forcing depository institutions to exercise setoffs at an earlier time. These adverse consequences are unnecessary and will be avoided if courts enforce the Bankruptcy Code as Congress enacted it.

Summary of Argument

In holding that an administrative freeze violates the automatic stay, the Fourth Circuit misconstrued the Bankruptcy Code.

First, the holding below nullifies the protection that the Bankruptcy Code explicitly and comprehensively accords a creditor with a right of setoff. (Point I) Although the *exercise* of the right of setoff is automatically stayed by a bankruptcy filing (11 U.S.C. § 362(a)(7)), the Code authorizes such a creditor to withhold payment of a debt owed the estate to the extent the debt is subject to setoff (11 U.S.C. § 542(b)), preserves the creditor's right of setoff under nonbankruptcy law (11 U.S.C. § 553(a)), provides such a creditor with a secured claim (11 U.S.C. §506(a)), authorizes the creditor to seek relief from the automatic stay (11 U.S.C. § 362(d)), and stipulates that estate property subject to a right of setoff may not be used unless the creditor's right of setoff is adequately protected (11 U.S.C. § 363(e)). The decision below sweeps away these interlocking statutory provisions that carefully accommodate the competing interests of the estate and of a creditor having a right of setoff, by interpreting the automatic stay as prohibiting a depository institution from even placing a hold on a debtor's account to the extent necessary to maintain the status quo with respect to the institution's right of setoff. If a debtor can require a depository institution that is also a creditor to pay an account balance that would otherwise be subject to the institution's right of setoff, the debtor can unilaterally abrogate and nullify the rights afforded by the Code to such a creditor.

Second, the court of appeals erroneously held that an administrative freeze "is tantamount to the exercise of a right of setoff and thus violates the automatic stay of § 362(a)(7)." JA 43a; 37 F.3d at 158. (Point II) In so holding, the court of appeals disregarded widely-accepted prerequisites of a setoff, which a freeze does not satisfy. The court of appeals also failed to reconcile its view concerning § 362(a)(7) with the Code provisions that preserve a creditor's right of setoff, as discussed above. Instead of construing the stay to preserve the status quo, the court of appeals interpreted the stay to enable a debtor to alter the status quo by defeating the setoff rights of a creditor.

Construing the automatic stay as preventing a creditor from maintaining an existing setoff right results in a deprivation of property without due process of law, in violation of the Fifth Amendment to the Constitution of the United States. (Point III) Finally, the result below contradicts the policy objectives as well as the express provisions of the Code. It penalizes a creditor for prepetition forbearance; forces increased bankruptcy filings by encouraging depository institutions to act quickly to exercise setoff rights when borrowers default outside of bankruptcy; and necessitates expensive and unnecessary emergency litigation at the beginning of a bankruptcy case. It will cause increased bank losses and more stringent credit terms. (Point IV)

ARGUMENT

I.

The Bankruptcy Code Authorizes an Administrative Freeze.

The commencement of a bankruptcy case creates an estate. 11 U.S.C. § 541(a). The estate consists of "all legal or equitable interests of the debtor in property as of the

commencement of the case." *Id.* Pursuant to this provision, a debtor's claim against a depository institution for payment of the balance of a deposit account becomes property of the estate. A deposit account represents a debt owed by the depository institution to its depositor, not an interest in cash or a specific fund or other identifiable property of the institution. *Barnhill* v. *Johnson*, 503 U.S. 393, 398 (1992). Through a carefully constructed statutory arrangement, in Section 553 and in several additional sections, the Bankruptcy Code recognizes and preserves the institution's right of setoff against such a debt.

The turnover obligation of an entity (such as a depository institution) that owes a debt that is property of a bankruptcy estate (such as a prepetition deposit account) is governed by Section 542 of the Code ("Turnover of property to the estate"), subsection (b) of which reads:

> "(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under Section 553 of this title against a claim against the debtor.*"

11 U.S.C. § 542(b) (emphasis added). It is thus beyond question that there is no turnover obligation in respect of a debt that can be offset.[2]

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[2] In this case turnover was demanded, not by a trustee, but by a debtor. Section 542(b) authorizes payment of a debt that is property of the bankruptcy estate only to the "trustee," not the debtor. Moreover, pursuant to Section 542(c), if a depository institution, with knowledge of the bankruptcy case, pays an account balance that is property of the estate to a debtor rather than a trustee, the institution is deemed not to have discharged its debt. If we assume, as did the court below, that a

(continued...)

The last clause of Section 542(b) authorizes a depository institution to impose an administrative freeze on a debtor's account by creating an exception to the obligation to pay a debt owed the estate (such as an account balance) to the extent the debt is subject to setoff pursuant to Section 553. *Stephenson* v. *Salisbury* (*In re Corland Corp.*), 967 F.2d 1069, 1077 (5th Cir. 1992) (allowing assertion of a right of setoff as a defense to a turnover action); *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995); *Moreira* v. *Digital Employees Fed. Credit Union* (*In re Moreira*), 173 B.R. 965, 966-67 (Bankr. D. Mass. 1994); *Crispell* v. *Landmark Bank* (*In re Crispell*), 73 B.R. 375, 379 (Bankr. E.D. Mo. 1987). An administrative freeze simply prevents inadvertent payment of an account balance to the extent necessary to maintain the depository institution's right of setoff.

The right to withhold payment of a debt under Section 542(b) is defined with reference to Section 553.[3] Section 553 is directly applicable to a depository institution that owes to a bankruptcy debtor a debt that arose before the bankruptcy case was filed (represented by the debtor's prepetition account balance) and that has a claim (based on a

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[2](...continued)

chapter 13 debtor may exercise a trustee's power under Section 542(b) to demand payment of an account balance that is property of the bankruptcy estate, the limitation that Section 542(b) imposes on the trustee must also apply to the debtor.

[3] Section 553 ("Setoff") provides in pertinent part:

> "(a) Except as otherwise provided . . . in Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ."

11 U.S.C. § 553(a).

loan) against the debtor that arose before commencement of the case. To the extent the depository institution has a right (by contract, statute or common law) to offset these obligations, that right is preserved explicitly by Section 553.

Although a creditor's exercise of its setoff right under Section 553 is subject to the provisions of Sections 362 (the automatic stay) and 363 (use, sale or lease of property of the estate), neither of those sections supports the result below.

Section 362(a) provides that the filing of a bankruptcy petition "operates as a stay" of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7). The purpose of this provision is to maintain — not to alter — the status quo.[4] As discussed in Point II, *infra*, Section 362(a)(7) prohibits only execution of a setoff, not a freeze that prevents nullification of a right of setoff. Section 362 also provides that the court shall grant relief from the stay under specified circumstances on request of a party in interest, 11 U.S.C. § 362(d), and as necessary to prevent irreparable damage to an interest of an entity in property, if such damage will be suffered before the request for relief from the automatic stay can be heard, 11 U.S.C. § 362(f).

Section 363 authorizes a trustee to use property of the estate, including property subject to setoff, in certain circumstances. A trustee may not, however, use property of the estate that is cash collateral (including a deposit account in which an entity other than the estate has an interest,

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[4] "Paragraph (7) stays setoffs of mutual debts and credits between the debtor and creditors. As with all other paragraphs of subsection (a), this paragraph does not affect the right of creditors. It simply stays its enforcement pending an orderly examination of the debtor's and creditors' rights." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 342 (1977); S. Rep. No. 95-989, 95th Cong. 2d Sess. 51 (1978).

11 U.S.C. § 363(a)) unless the entity having an interest in the cash collateral consents or the court, after notice and a hearing, authorizes such use in accordance with the provisions of Section 363. 11 U.S.C. § 363(c); *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994). Any entity having an interest in cash collateral or other property of the estate, moreover, is entitled on request to an order prohibiting or conditioning use of the cash collateral or other property to the extent necessary to provide adequate protection of the entity's interest. 11 U.S.C. § 363(e).

The foregoing provisions contemplate that a depository institution is entitled in the first instance to withhold payment of a debt represented by a debtor's account balance to the extent the balance is subject to a right of setoff. An administrative freeze simply implements the creditor's right under Section 542(b) to withhold payment. It is a procedural action which does not change the substantive rights of the parties. It prevents nullification of the creditor's setoff right preserved under Section 553 and maintains the status quo until the parties agree or a court orders otherwise. The creditor may move for relief from the automatic stay, and if such relief is granted execute the setoff. Assuming a setoff has not been authorized, the trustee (or, in this case, the Chapter 13 debtor) may apply for authorization to use cash collateral (*i.e.*, the account balance subject to the creditor's right of setoff), subject to the creditor's right to adequate protection. *See Bank of America* v. *Edgins* (*In re Edgins*), 36 B.R. 480, 483 (Bankr. 9th Cir. 1984).

Until the court either grants relief from the automatic stay or authorizes the debtor to use cash collateral, the creditor may continue to withhold payment of the amount subject to a right of setoff. Indeed, the Code specifically provides a creditor that has a right of setoff with a secured claim to the extent of such right. 11 U.S.C. § 506(a). In either Chapter 11 or Chapter 13, a plan may not be

confirmed unless the holder of a secured claim retains its lien or its equivalent. 11 U.S.C. §§ 1129(b), 1325(a)(5).

An administrative hold is thus authorized by Section 542(b) and simply maintains the status quo. While it is true that a hold prevents a debtor from obtaining payment of an account balance, a debtor is not entitled under Section 363 to use such balance without obtaining court approval, which at the creditor's request must be conditioned on providing adequate protection.

The court of appeals gave short shrift to the Code provisions that protect a creditor's right of setoff. Section 542(b) is mentioned in a footnote (JA 41a; 37 F.3d at 157 n.*) but is otherwise ignored, even though it should have been dispositive of the issue before the court of appeals. The court of appeals devoted more attention to Section 553(a), but construed Section 362(a)(7) in a way that nullifies the setoff rights that Section 553 explicitly preserves. Similarly, the court of appeals acknowledged that a creditor is entitled to request relief from the automatic stay under Section 362, but nonetheless deemed a refusal to pay an account balance while the request is pending as a violation of the stay. As a result, the creditor would be powerless to prevent a debtor from rendering moot the request for relief from the automatic stay. The court of appeals made no reference to Section 363 or any of its limitations on a trustee's powers or its protection of rights of creditors.

The justification offered by the court of appeals for an interpretation of Section 362(a)(7) that effectively repeals numerous creditor protections explicitly set forth elsewhere in the Code was not based on the words of the statute. Rather it was based on a policy argument, contained in the conclusory assertion that "If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished." JA 45a; 37 F.3d at 159 (*quoting*

United States v. *Norton*, 717 F.2d 767, 773 (3d Cir. 1983)). Even assuming this to be so, the Code does not provide for rehabilitation of a debtor at all costs; rather that goal must be pursued in comity with the rights of creditors. Rights accorded creditors by the Code may not be written out of the Code by a court, even though such rights may hinder or defeat a particular debtor's rehabilitation. *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206-07 (1988); *Air Atlanta, Inc.* v. *National Bank of Georgia*, 81 Bankr. 724 (N.D. Ga. 1987).

Moreover, it is not at all clear why a freeze that protects a right of setoff should prevent successful implementation of a chapter 13 plan, the objective of which is to enable a debtor to pay creditor claims from disposable income during the term of the plan. Such a plan must in any event provide that a secured creditor retains its lien (*i.e.*, in this co ntext, its right of setoff). 11 U.S.C. § 1325(a)(5). The debtor in the meantime can seek relief from the court to obtain access to its deposit account, provided that the depository institution is afforded adequate protection.

In sum, the court of appeals erred by failing to give effect to the limitations on a depository institution's turnover obligation under Section 542(b), the preservation of the institution's right of setoff under Section 553, the institution's right to seek relief from the automatic stay under Section 362(d) (which would be nullified should the institution be required to pay the account balance subject to setoff without being provided with adequate protection), and limitations upon the power of a debtor to use cash collateral under Section 363 (c) and (e) (which require court approval and adequate protection). The Fourth Circuit swept away all the foregoing rights of the institution, and limitations on the powers of the debtor, based on the mistaken conclusion that a freeze in these circumstances is "tantamount to setoff" and is thus stayed by Section 362.

II.

A Freeze Is Not a Setoff and Thus Does Not Violate Section 362(a).

The filing of a bankruptcy petition "operates as a stay, applicable to all entities, of . . . the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7).

By its terms, Section 362 (a) provides for a "stay." That is, it operates to maintain the status quo, protecting the estate from dismemberment while the case is being administered.[5] The fundamental error of the court of appeals was to treat the automatic stay as a substantive rather than a procedural provision, to abrogate and defeat a creditor's substantive right of setoff. The court of appeals' decision alters the status quo which Section 362 is designed to preserve by prohibiting the creditor from maintaining it.

A freeze is not a setoff because a freeze does not change the debtor's account balance or loan balance or the parties' obligations. A setoff, by contrast, changes all three. Moreover, a setoff has not occurred unless there has been (1) a decision to effectuate a setoff, (2) an overt act accomplishing the setoff, and (3) a record of the setoff. *See*, *e.g.*, *Horton Dairy, Inc.* v. *United States*, 986 F.2d 286, 291 (8th Cir. 1993). The status quo is altered when a setoff is effected (because the loan and account balance are reduced to the extent they are offsetting) *or* when the account balance subject to a right of setoff is withdrawn by a debtor; a freeze maintains the status quo (*i.e.*, the existing account balance

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[5] The legislative history confirms that the automatic stay does not affect the rights of creditors but simply stays enforcement of such rights. *See* note 4 *supra*.

and loan balance). Therefore an administrative freeze does not satisfy the prerequisites for a setoff. *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995); *Moreira* v. *Digital Employees Fed. Credit Union* (*In re Moreira*), 173 B.R. 965, 967 (Bankr. D. Mass. 1994); *Crispell* v. *Landmark Bank* (*In re Crispell*), 73 B.R. 375, 379 (Bankr. E.D. Mo. 1987).

The court of appeals sought to justify its equation of a freeze with a setoff by observing that "both effectively deprive the debtor of use of the funds." JA 43a; 37 F.3d at 158. In fact, Section 363(c) prohibits the use of cash collateral (such as a deposit account subject to a right of setoff) without court approval or consent of the creditor. An administrative freeze may prevent a debtor from ignoring the requirements of Section 363(c), but a creditor does not violate the automatic stay merely by requiring the debtor to follow procedures that the Code independently requires. Moreover, as set forth above, the creditor's withholding of payment is expressly authorized by Section 542(b). In expanding the meaning of "setoff" to include the mere withholding of payment, the court of appeals erroneously disregarded the established elements of a completed setoff (which the mere withholding of payment does not satisfy), and thereby brought Section 362(a)(7) into conflict with the Code provisions that preserve setoff rights.

The court of appeals did not analyze the relationship between Section 362(a) and the other Code provisions that are relevant to the issue presented, nor did the court of appeals attempt to reconcile its position that a freeze is "tantamount to a setoff" with the material substantive differences between the two. Instead, the court of appeals relied upon three other appellate decisions, *Small Business Admin.* v. *Rinehart*, 887 F.2d 165 (8th Cir. 1989) and *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985), both of which in turn rely upon *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983). None of those earlier court of appeals decisions reconciles its holding with the Code provisions protecting rights of setoff

or the generally-recognized prerequisites of setoff, and bankruptcy courts in other judicial circuits, recognizing these defects, have refused to follow *Norton* and its progeny. *See, e.g.*, *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995).

In fact, *Norton*, the foundation of these court of appeals decisions, itself rests upon a peculiarity of the law of Pennsylvania and is therefore irrelevant to this and most other cases. *See United States* v. *Norton*, *supra*, 717 F.2d at 772.[6] Even when that peculiar rule is applicable, Section 362(a)(7) prevents occurrence of a setoff by operation of law, so that the creditor may maintain the status quo by withholding payment of an account balance to the extent the creditor has a right of setoff, as provided in Section 542(b). None of the courts of appeals that has addressed this issue has given proper consideration to Section 542(b) or to the peculiarity of Pennsylvania law upon which *Norton* was based.

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[6] *Norton* looked to Pennsylvania law to determine whether a setoff had occurred and concluded that under Pennsylvania law a setoff is accomplished when a creditor gives sufficient evidence of intent to make a setoff, and that the retention of a debtor's funds by a creditor is sufficient evidence of that intent. *United States* v. *Norton*, 717 F.2d at 772. This statement of Pennsylvania law in *Norton* was at variance with the Third Circuit's earlier decision in *Pittsburgh National Bank* v. *United States*, 657 F.2d 36 (3d Cir. 1981), which found that under Pennsylvania law a setoff occurs by operation of law the moment a creditor's claim matures. Had the Third Circuit in *Norton* adhered to *Pittsburgh National Bank*'s reading of Pennsylvania law, it would have concluded that either a setoff occurred by operation of law prior to the bankruptcy filing (in which case the creditor would no longer owe the debt that had been offset) or that the automatic stay prevented a setoff by operation of law post-petition. In neither case was *Norton* justified in equating a withholding of funds with a setoff. *Reinhart*, *Reynolds* and the decision below followed *Norton* even where Pennsylvania law was inapplicable.

The only additional statutory authority cited by any of these decisions is Section 362(a)(3), which provides for a stay of any act "to exercise control over property of the estate." *See Small Business Admin.* v. *Rinehart*, *supra*, 887 F.2d at 168. Clearly, however, this language cannot be read so broadly as to cover a refusal to pay a debt where such refusal is authorized by the Code, and an administrative freeze is nothing more than that. The language of Section 362(a)(3) must be interpreted in harmony with other provisions of the Code, and in particular should not be read to stay conduct that is otherwise authorized by the Code.[7] *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994); *National Bank of Georgia* v. *Air Atlanta* (*In re Air Atlanta, Inc.*), 74 B.R. 426, 427 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987); *Williams* v. *American Bank of the Mid-Cities, N.A.* (*In re Williams*), 61 B.R. 567, 586 (Bankr. N.D. Tex. 1986).

In the case of a deposit account, the estate's property right is a claim against the depository institution; the estate has no property interest in the institution's cash, which is the institution's property. The institution has no control over the estate's claim against the institution, and the refusal to pay the balance (unlike a setoff) does not extinguish or otherwise alter the claim. Nonpayment of a debt that is property of the estate should not be deemed a violation of the automatic stay when nonpayment simply preserves a right of setoff and is thus authorized explicitly by Section 542(b). Indeed, under Section 542(b), a right of setoff is a defense to a demand for turnover. *Stephenson* v. *Salisbury*, *supra*, 967 F.2d at 1077. The assertion of the defense provided by the Code cannot be a violation of the automatic stay.

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[7] Reading Section 362(a)(3) in isolation from other Code provisions leads to results that plainly were not intended. For example, because Section 362(a)(3) applies to all entities, if read in isolation it would prohibit a debtor or trustee, as well as a creditor or other entity, from exercising any control over property of the estate.

The court of appeals erred by applying Section 362(a) not as a stay, but to defeat substantive rights, including rights specifically provided in Sections 553(a) and 542(b). The automatic stay, like the exception under Section 542(b) to the obligation to make payment of a debt owing to the estate, is intended to preserve the status quo. A depository institution's nonpayment of an account balance subject to a right of setoff preserves the status quo until the court authorizes the creditor to effect a setoff, or the debtor to use the account balance after providing adequate protection, or the matter is resolved through a plan or liquidation, in which case the creditor's rights as the holder of a secured claim would be recognized. The result below, by contrast, defeats the status quo and the creditor's right of setoff by permitting a debtor to obtain payment in full of the debtor's account balance.

III.

Construing the Automatic Stay to Prohibit an Administrative Freeze Results in a Deprivation of Property Without Due Process of Law.

A depository institution's right of setoff is not only a contractual right, but also a property interest in the debtor's account balance. The property interest arises from setoff rights that are widely recognized by statute and by common law, and from Section 506(a) of the Bankruptcy Code, providing that a creditor with a right of setoff holds a secured claim to the extent of the setoff right. *See In re Lawndale Steel Co.*, 155 B.R. 990, 992 (Bankr. N.D. Ill. 1993). A secured creditor's interest in a debtor's property is a property interest of which a creditor may not be deprived without due process of law. *United States* v. *Security Industrial Bank*, 459 U.S. 70 (1982). *See* U.S. CONST., amend. V.

The Bankruptcy Code, as any other statute, should be construed so as not to conflict with the Constitution. *Edward J. DeBartolo Corp.* v. *Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568 (1988). Interpretation of the Bankruptcy Code in a manner that nullifies a creditor's right of setoff creates a wholly unnecessary conflict with the Constitution. The constitutional conflict is avoided by giving effect to the explicit protection of creditor interests set forth in Section 542(b) and in the other Code provisions discussed above.

IV.

The Rule Applied by the Court of Appeals Will Have Adverse Consequences for Debtor-Creditor Relations and for the Administration of Bankruptcy Cases.

The rule applied by the court of appeals encourages prepetition setoffs and emergency litigation at the commencement of a bankruptcy case, neither of which is desirable.

A financial institution that has an opportunity to exercise a right of setoff (typically, because a borrower has defaulted under a loan agreement) faces a prepetition choice between action (implementing the setoff) and forbearance. Forbearance provides the best opportunity for rehabilitation. Prepetition setoff encourages bankruptcy. The Code recognizes the desirability of forbearance by preserving the creditor's right of setoff as described above and thereby protecting the creditor after the petition is filed.

The Fourth Circuit's policy choice, that a freeze would diminish a debtor's chances for rehabilitation, 37 F.3d at 159, is at odds with the policy of Section 553 and the other provisions described above and penalizes the creditor for forbearing. Instead of encouraging financial institutions to give

borrowers leeway to straighten out their affairs without having to file under the Code, the decision below discourages forbearance and will result in more bankruptcy filings. As such, the decision is utterly at odds with established bankruptcy policy.

Section 542(b) clearly contemplates that a depository institution with a right of setoff may withhold payment of an account balance to the extent it is subject to setoff. The creditor may then move for relief from the automatic stay if it chooses to do so. The debtor may apply for permission to use cash collateral if it chooses to do so. Or the parties may negotiate a compromise, thus minimizing the need for judicial involvement.

The decision of the court of appeals, by contrast, makes it virtually impossible for a depository institution to preserve a right of setoff. A depository institution could conceivably obtain *ex parte* an order authorizing a freeze pending a hearing on a request for relief from the automatic stay, as suggested by the Fourth Circuit, *see* JA 41a-42a; 37 F.3d at 157-58, but the timing and result are uncertain, and there is nothing in the Code that mandates or encourages *ex parte* litigation to preserve rights the Code already affords. If the debtor demands the account balance before a court order authorizes a freeze, in the court of appeals' view the institution is powerless to preserve its right of setoff. By writing the Section 542(b) exception out of the Code, this result also makes it incumbent upon the depository institution to commence emergency litigation, with attendant expense to the creditor and the debtor and burden upon the bankruptcy court, if the creditor is to have any hope of preserving its setoff right. Such litigation is obviated, without compromising the substantive rights of the debtor or the creditor, if

Section 542(b) and Section 363, along with Section 362, are recognized as controlling.[8]

In sum, the Bankruptcy Code already provides the rules and procedures applicable in these circumstances, and there are good reasons not to substitute the court of appeals' suggested policies and procedures for what the Code requires.

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[8] One court of appeals has held that a depository institution may protect its setoff right when a check is presented for payment of an account balance subject to setoff by filing an *ex parte* motion under Sections 362(f) or 363(e), accompanied by payment of the account balance into the registry of the bankruptcy court, provided it does so by midnight on the next banking day after it receives the check. *B.F. Goodrich Employees Fed. Credit Union* v. *Patterson* (*In re Patterson*), 967 F.2d 505, 511 (11th Cir. 1992). Nothing in the Bankruptcy Code mandates such a cumbersome and expensive procedure — or indeed any procedure — as a prerequisite to the depository institution's exercise of its right to withhold payment of an account balance to the extent of the institution's right of setoff.

Conclusion

For the reasons stated, the decision below should be reversed.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1995

CITIZENS BANK OF MARYLAND,
Petitioner,
v.
DAVID STRUMPF,
Respondent.

BRIEF OF BANKAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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BRIEF OF BANKAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

BankAmerica Corporation ("Amicus") is a bank holding company which, through its subsidiaries, transacts banking business on a national basis. Amicus currently operates banks which provide deposit account services on over fifteen million accounts with over $120 billion on deposit in 13 states. The Fourth Circuit's ruling in this case directly affects Amicus's dealings (through its subsidiaries) with significant numbers of depositors who commence bankruptcy proceedings each year. These deposit accounts are accorded the protection of and are deemed security for repayment of obligations owing to the banks pursuant to §506(a) of the Bankruptcy Code[1]. Amicus therefore has a

[1]The United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*, referred to hereafter as the Bankruptcy Code.

great stake in the proper interpretation of the Bankruptcy Code provisions at issue here to insure that its property rights in the deposit accounts are preserved.

The judgment of the United States Court of Appeals for the Fourth Circuit is manifestly incorrect. If the Fourth Circuit's judgment is allowed to remain the law, Amicus and other depositories will be required to forego statutorily granted property rights without a hearing or other due process of law in order to avoid liability for contempt. This result conflicts with constitutional principles and the Bankruptcy Code itself.

Because of this case's substantial impact on the banking community, Amicus believes that its views on the proper interpretation of the law may be of assistance to the Court's consideration of this case.

QUESTION PRESENTED FOR REVIEW

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights, without violating the bankruptcy stay under 11 U.S.C. § 362(a).

INTRODUCTION AND SUMMARY OF ARGUMENT

The United States Court of Appeals for the Fourth Circuit has effectively stood the Bankruptcy Code on its head by misinterpreting a procedural device so as to invalidate a substantive property right. The Fourth Circuit mistakenly found a depository bank's administrative hold on a bankruptcy debtor's demand deposit account "tantamount to the exercise of a right of setoff" and in violation of the automatic stay of §362(a)(7). *In re Strumpf*, 37 F. 3d 155, 158 (4th Cir. 1994). Thus, the debtor had the right to immediate withdrawal of the funds on deposit. The depository bank's right of setoff, which is a protected security interest under the Bankruptcy Code, was destroyed.

If the decision below is allowed to stand, a depository bank holding cash subject to a right of setoff has absolutely no way to protect itself from a debtor who withdraws cash post-petition, since the bank cannot put an administrative hold on the account. By the time the bank obtains hollow judicial relief, the cash will have been dissipated beyond recovery. The effect of the Fourth Circuit's error is to deny banks and other depository institutions a substantive property right without notice or opportunity to be heard, thereby denying due process of law as guaranteed under the Fifth Amendment to the United States Constitution.

It is essential to keep two incontrovertible concepts firmly at hand. First, a demand deposit account is merely a payable on the books of the depository, not a discrete fund of a depositor's money held in trust. *Keller v. Fredericktown Sav. Inst.*, 66 A. 2d 924, 925 (Md. 1949); *Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold*, 608 A. 2d 1194, 1201 (Md. App. 1992). Second, the Bankruptcy Code makes no distinction between the setoff rights of a depository and those of any other creditor. Rather, it is the courts which have created unwarranted distinctions between classes of creditors holding setoff rights.

The issue of setoff is perhaps most focused with depositories due to the ease with which demand deposit accounts are accessed. Unique among creditors who may assert setoff rights, the depository is faced with an immediate demand for turnover of funds through the presentation of a draft or check for payment. The depository must then either honor the check, thereby losing the right to setoff mutual obligations, or dishonor the check and preserve such rights. If the second course is chosen, the depository "freezes" or holds the account. This administrative hold properly should not be

viewed as an act but as a refusal to act in the face of an unlawful attempt by the debtor to withdraw funds.

The result below is based on multiple misreadings of the Bankruptcy Code. The briefs of Petitioner, and other parties allied with Petitioner, will address the manifest statutory errors of the Fourth Circuit's interpretation of §§ 362(a)(7), 553, and 542(b) of the Bankruptcy Code. Therefore, this amicus brief will focus solely on the constitutional issue.

Amicus urges the Court to dispose of this case on statutory grounds, thereby avoiding the Fifth Amendment issues. *See, e.g., Edward J. DeBartolo Corp. v. Florida Gulf Coast Building and Construction Trades Council*, 485 U.S. 568, 575, 108 S. Ct. 1392, 99 L. Ed. 2d 645 (1988) ("[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress"). Here, the Fourth Circuit's construction of the Bankruptcy Code was not "otherwise acceptable"; but even if it were, Amicus respectfully submits that this Court should construe the statutes so as to forestall the constitutional issue. However, if the Court finds constitutional analysis necessary, Amicus respectfully submits that the Fourth Circuit's decision creates a clear violation of the Fifth Amendment.

ARGUMENT

THE FOURTH CIRCUIT'S INTERPRETATION OF § 362(a)(7) OF THE BANKRUPTCY CODE RESULTS IN A TAKING OF PROPERTY WITHOUT CONSTITUTIONALLY PROTECTED DUE PROCESS OF LAW

The Fourth Circuit has interpreted § 362(a)(7) to prohibit an "administrative freeze" intended to preserve the

right of setoff recognized by § 553(a). Amicus respectfully submits that the Fourth Circuit erred in its interpretation, with the result that Petitioner was denied its property without a hearing and without due process of law.

A. SECTION 506(a) OF THE BANKRUPTCY CODE CONFERS SECURED STATUS ON CREDITORS HOLDING A RIGHT OF SETOFF

Section 506(a) of the Bankruptcy Code accords the status of a secured creditor to a party holding rights of setoff, to the extent of the amount subject to setoff. Section 506(a) provides: "An allowed claim of a creditor ... that is subject to setoff under section 533 of this title, is a *secured claim* ... to the extent of the amount subject to setoff...." [Emphasis added.] The legislative history of the Bankruptcy Code demonstrates that Congress carefully delineated the right of setoff as a secured claim:

> Section 506(a) of the House amendment adopts the provision contained in the Senate amendment and rejects a contrary provision as contained in H.R. 8200 as passed by the House. The provision contained in the Senate amendment and adopted by the House amendment recognizes that *an amount subject to set-off is sufficient to recognize a secured status in the holder of such right.* [124 Cong.Rec. S17403, S17411 (October 6, 1978); emphasis added.]

Thus, a depository bank holding a right of setoff is a secured creditor holding a secured claim, as a matter of Federal law.

The legal effect of such status is that the property subject to the setoff cannot be used, sold or leased unless the secured creditor consents or the Court, with or without a hearing, determines that such property interest is adequately

protected.[2] This does not mean, however, that the party holding setoff rights may enforce them. The automatic stay of § 362(a)(7) acts as a counterbalance, and restrains setoff until the Court grants relief from stay to effect the setoff.

The Fourth Circuit balanced § 553 against § 362 and erroneously ruled that the stay against setoff compelled Petitioner to turn over the funds in debtor-Respondent's checking account to Respondent, thereby destroying Petitioner's setoff rights, on pain of contempt. Thus, in effect, the stay provision was used to trump Petitioner's substantive setoff rights, and allowed Respondent access to funds which it was legally unable to use without affording adequate protection.

B. THE DESTRUCTION OF A SECURED CLAIM IS A TAKING UNDER THE FIFTH AMENDMENT TO THE CONSTITUTION

The Fifth Amendment declares that no person shall be "deprived of life, liberty, or property, without due process of law . . . ." The Fourth Circuit's opinion creates a violation of this principle.

This Court addressed the interplay between the Bankruptcy Code and the Fifth Amendment in the case of *U. S. v. Security Industrial Bank*, 45 U. S. 70, 103 S. Ct. 407, 74 L. Ed. 2d 235 (1982), in which the Court held that the Bankruptcy Code cannot be construed so as to destroy the property rights of secured creditors. The holder of a setoff right recognized by § 553 of the Bankruptcy Code is ac-

[2]Section 363(e), as relevant, provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

corded the legal status of a secured creditor and holds a secured claim to the extent of the amount subject to setoff. *See* § 506(a); *Matter of Lawndale Steel Co.*, 155 Bankr. 990, 992 (Bkrtcy. N.D.Ill. 1993). The question at issue in *Security Industrial* was whether § 522(f) of the Bankruptcy Code could be applied to allow a debtor to avoid a non-purchase money, non-possessory security interest in personal property pre-existing the effective date of the Bankruptcy Code. To avoid a taking under the Fifth Amendment, the Court declined to apply this statute retrospectively. The Court examined the relationship between the bankruptcy statutes and the Fifth Amendment, and noted that if a bankruptcy statute destroys property rights, the statute cannot be defended on "rational basis" grounds:

> It may be readily agreed that § 522(f)(2) is a rational exercise of Congress' authority under Article I, Section 8, Clause 4, and that this authority has been regularly construed to authorize the retrospective impairment of contractual obligations . . . . Such agreement does not, however, obviate the additional difficulty that arises when that power is sought to be used to defeat traditional property interests. *The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation* . . . . Thus, however "rational" the exercise of the bankruptcy power may be, that inquiry is quite separate from the question whether the enactment takes property within the prohibition of the Fifth Amendment. 459 U. S. at 74-75 (citations omitted and emphasis added).

The Court carefully distinguished between the rights of secured and unsecured creditors, rejecting the argument of the government that a secured party's rights are deserving of no greater protection under the takings clause than traditional contract rights. *Id.* at 75. The Court stated: "However

'bankruptcy principles' may speak to this question, our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right to the same creditor in the collateral." *Id.*

The Court then discussed the cases establishing that the destruction of a lien is a taking. The government argued that the bankruptcy law had simply imposed a general economic regulation which in effect transferred the property interest from a private creditor to a private debtor, and therefore was not a taking because the government had not acquired for itself the property in question. *Id.* at 78, 79. The Court, however, refused to permit the destruction of a secured creditor's lien rights without affording that secured creditor due process of law.

The analysis in *Security Industrial* applies forcefully to the facts of this case. If § 362(a)(7) is so broadly interpreted as to permit a debtor to take and spend funds subject to the right of setoff, then the right of setoff becomes meaningless as a practical matter. If the insolvent debtor is permitted immediate and unfettered access to its funds, the funds will be irretrievably dissipated and the bank's property rights as secured creditor will have been destroyed — unconstitutionally taken — by the Bankruptcy Code. *See In re George Ruggiere Chrysler-Plymouth*, 727 F. 2d 1017, 1019 (11th Cir. 1984) ("the Bankruptcy Court cannot allow the secured interest to be threatened by improper use of cash proceeds").

The destruction of the right of setoff is, in essence, the taking of the depository bank's cash collateral. Congress expressly recognized the Fifth Amendment issues raised by

the use of cash collateral, and consequently enacted the adequate protection standards set forth in § 361:

> The concept [of adequate protection] is derived from the fifth amendment protection of property interests. *See Wright v. Union Central Life Ins. Co.*, 311 U. S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555 (1935). It is not intended to be confined strictly to the constitutional protection required, however. The section, and the concept of adequate protection, is based as much on policy grounds as on constitutional grounds. *Secured creditors should not be deprived the benefit of their bargain. . . .*

H.R. Rep. No. 95-595, 95th Cong., 1st Sess., *reprinted in* U.S.C.C.A.N. 5787, 6295 (emphasis supplied). *See also In re Born*, 10 Bankr. 43, 48 (Bkrtcy. S.D. Tex. 1981) ("The very heart of the concept of adequate protection is to assure the secured creditor that as the bankruptcy procedures unfold he will not be faced with a decrease in the value of his collateral"). In order to prevent unconstitutional takings, the Bankruptcy Code requires (among other things) a hearing prior to the use of cash collateral under 11 U.S.C. § 363(c)(2)(B): "The trustee may not use . . . cash collateral . . . unless (2) the court, after notice and a hearing, authorizes such use . . . ." In keeping with Congressional deference to the Fifth Amendment, the setoff provisions in the Bankruptcy Code should also be interpreted so as to preserve the depository bank's cash collateral.

As demonstrated in Petitioner's brief, there is no reason to reach this conflict between Fifth Amendment and bankruptcy law, because when Congress enacted the Bankruptcy Code it specifically protected setoff rights against such an

unconstitutional taking. In its ruling, the Fourth Circuit simply ignored § 542(b), which provides:

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under Section 553 of this title against a claim against the debtor.* [Emphasis added.]

Section 542(b) is relegated to a mere footnote in the Fourth Circuit's opinion. *Strumpf*, 37 F.3d at 157, fn. *. By failing to consider Section 542(b), the Fourth Circuit construed the Bankruptcy Code so as to create a violation of the Fifth Amendment. The view of the Fourth Circuit should be rejected, and the Bankruptcy Code should be interpreted in a manner consistent with the Fifth Amendment.

CONCLUSION

Banks and other depositories are not the only creditors who hold rights of setoff recognized by the Bankruptcy Code, but they are uniquely affected by the Fourth Circuit's ruling. Other creditors who may have rights of setoff are not required by the Fourth Circuit's opinion to forfeit their rights in order to avoid contempt. *The opinion appears to apply only to deposit accounts.*

In order to protect its setoff rights, the bank or other depository should be able to place an administrative freeze on the funds, which will preserve the *status quo* and prevent an unconstitutional taking of the bank's secured claim. This Court should construe the applicable provisions of the Bankruptcy Code to avoid destroying banks' secured rights in violation of the Fifth Amendment. In this manner the constitutional and economic rights of the parties can be

protected. For the foregoing reasons, Amicus urges that this Court reverse the decision of the Fourth Circuit.

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